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CHARTERED FINANCIAL

ANALYST

January 2003 | The New Age Finance Magazine | Rs.50

30.06.03

BPO: Advantage India

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P17280

CHARTERED FINANCIAL
ANALYST
Vol-IX, Issue - 1 January 2003

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E-Mail serv@icfaipress org, Website www icfaipress org
ISSN 0972-5053

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Printed and published by E N Murthy on behalf of The Institute of Chartered Financial Analysts of India, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh. Printed at M/s ICIT Software Center Pvt Ltd. (Press Division), 3-112, Fatehnagar, Sanathnagar (P O), Hyderabad - 500 018, (A P) and published from The Institute of Chartered Financial Analysts of India, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082 (A P)
Editor E N Murthy

BPO: Let a Thousand Flowers Bloom

Today's global corporations are global in every sense of the word with operations spread across the globe. As companies expand, a number of non-core but necessary processes emerge. These processes involve costs besides demanding time and energy of the management.

In the new scheme of things, Business Process Outsourcing comes as a natural solution that eliminates the concerns of organization on non-core operations, thus freeing the resources to focus on building core competence. Nike, the largest supplier of athletic shoes in the world outsources 100% of its shoes production. It concentrates on research, marketing and distribution while manufacturing only the key technical components of Nike Air System. Outsourcing non-core processes to offshore centers brings in enormous cost savings, which could translate to wealth creation for shareholders; the reason why BPO has become the new buzzword.

With many companies looking for opportunities to outsource, the global BPO market is bound to grow. Today it is pegged at $200 bn and is expected to grow at 15-20% per annum. India is positioned to capture a sizable chunk of the global pie in outsourcing. The reasons include cost advantages, availability of talented workforce, improving infrastructure, geographical location and the resultant time difference. The encouraging attitude of the government is another positive factor in India's attractiveness. Nevertheless, security concerns and infrastructure bottlenecks have to be eliminated if the opportunity is to translate into hard cash.

BPO translates into enormous business opportunity for India. IT-enabled services, as they are also called, are expected to be around $18.6 bn by 2008 employing approximately 1.1 million people. The possibilities of BPO have attracted many a company to set up shop thus making the sector crowded. This is likely to lead to inevitable consolidation leaving the industry with a few dominant players. The key to success in the long-term would be in expanding the breadth of services as well as meeting customer requirements. Irrespective of the form, be it captive center or third party provider, BPO is bound to have a positive impact on the Indian economy letting thousands of flowers bloom.

Ch Rajeshwer

8% Growth – Raising the Bar

After growing in the range of 5-6.5% for some time now, the bar for India's GDP has now been raised to 8%. While skeptics shrug it off as yet another pipe dream, die-hard optimists believe it is very much within reach. However, they all agree that if India has to achieve that magic number, it has to go whole hog in removing all the bottlenecks. First of all, the government has to rein in the age-old habit of fiscal profligacy. What would it mean is bringing down the levels of fiscal deficit and revenue deficit to a more comfortable 4.6% and 3% respectively from 5.8% and 4% recorded in 2001-02. But that seems to be a tall task given the lack of will-power among our politicians and compulsions of a coalition government at Center.

The pace of disinvestments is what many economists say would decide whether we grow at that level or not. However, a poor record of the government on that front too paints a rather bleak picture; during the last three fiscal years ending March 2002, the government could succeed in meeting just about 46% of the divestment target. Furthermore the frequent dithering and dilly-dallying over the rest of the divestment candidates has jeopardized the prospects of mopping up the revenues.

A growth rate of 8% would require the domestic industry to grow by at least 12%, while agriculture has to grow by at least 4% a year. Importantly, the key to 8% growth rate would be to step up rural demand that would, in turn, generate higher demand for the domestic industry. The high production levels also have to be matched with a healthy balance of payment situation and higher foreign direct investments. However, all this would be possible only if the fiscal deficit of the Center is contained within 4%, which looks like a distant scenario at the moment. Also, as far as attracting FDIs are concerned, the situation, according to some experts, looks less optimistic with India's slow rate of reforms. Another concern is related to the condition of the state finances, which are in dire straits; according to some rough estimates, the outstanding debt of all the states together more than doubled from Rs. 243,000 cr in March 1997 to about Rs. 500, 000 cr in March 2001, which experts say is potentially disastrous

However, there are enough examples of countries that achieved such a stupendous performance. Japan achieved it in the 1950s and the 1960s; Korea and Taiwan in subsequent decades; Thailand, Malaysia, Singapore in the 1980s and early 1990s; and China for over two decades now. India can do well to take a leaf or two from their books. Do the country's masters have the will? Only time will tell

Amit Singh Sisodiya

EU Enlargement: Is Big Better?

Ever since the creation of the European Union, it has been shadowed with problems. In spite of the structural problems that EU has experienced over the years, economists were confident that EU would shrug them off and boost a good economic growth. However, it could only record a growth of 0.4% in the first quarter of 2002 and a mere 0.3% in the second quarter.

The slow growth is straining the euro-area's budgetary rules and the stability and growth pact. The major reason behind this is to prevent the member country government from running fiscal policies that can hurt the other member states. The Maastricht Treaty, while laying down the rules for euro membership stipulated governments to meet targets on inflation, interest rates, public debt and fiscal deficits. However, four of the 12 euro-area governments are off-target on fiscal deficits and inflation—Germany, France, Italy and Portugal. At the beginning of the year these governments had promised to bring down their budgets, 'close to balance' by 2004. But, with poor growth the deadline may be pushed backwards. Germany is aiming for 2006. France's commitment is based on the economic growth of 3% in 2003. Going by the current trends, this looks impossible.

Since the major economies of the euro-area are under severe strain, the possibility of easing the pact cannot be ruled out. Obviously, Italy, France and Germany would like to see the easing of the pact. However, the ECB president is vehemently against this move and has pointed out to the member states to avoid deficits in excess of 3% of GDP and implement determined policies to progress towards close to budgets or surplus. But with the prevailing policies it becomes increasingly difficult for the member countries to adopt stringent economic policies. This catch-22 situation of the member countries is leading to serious concerns about the stability pact.

While the concerns over the EU stability and growth pact are being expressed, EU has announced that 10 new countries will be joining EU in 2004. Will the joining of new countries provide a solution to EU's problem is one obvious question that is doing rounds now. Perhaps, the enlarged area would contribute to EU's economic growth, new trade and investment opportunities. The growth rates of the top five candidate countries such as Czech Republic, Hungary, Poland, Slovenia and Estonia were very high as compared to the EU. However, the new countries also have high budget deficits, which can delay the entire process of integration. Can the EU afford to have more states with high deficits when it is not able to cope with the existing problems itself?

Y Chandra Sekhar

TRIGGERS

Federal Reserve – Out of Bullets?

A rate reduction is clearly the most powerful weapon the Fed has in its arsenal to counter negative economic sentiment that has been mushrooming on Wall Street and Main Street. However, as short-term interest rates have edged closer to zero, the latest rate cut signals that the Fed's round of rate-slashing may be near its end. The current environment of low inflation and concerns about the recovery have raised questions whether the Fed will eventually run out of room to lower interest rates enough to stimulate the economy.

The Fed's next policy meeting is set for January 28, 2003; many observers expect no increase in rates then either However, the central bankers in the US say they have plenty of room to cut rates further if needed. Even if rates were brought to zero, the Fed could boost the economy by buying back securities and other instruments to flood the economy with cash. Some experts say the Fed should keep ammunition in storage.

Economists see the action as an attempt by the Fed to accelerate aggressively a sluggish economy. The Fed took a shotgun approach this time as it sends a huge psychological impact to investors and consumers that they want to keep economic expansion intact. Until now, Wall Street has thrived on the certainty that interest rates would fall.

Now it faces uncertainty over how quickly and effectively lower rates will fix an economy hung over from overspending on technology

However, for the foreseeable future, then, the Federal Open Market Committee continues to believe that, "... the risks are weighted mainly toward conditions that may generate economic weakness." In other words, the economic problems are worldwide and the Fed is clearly prepared to take those actions that will get the economy going.

But some economists cautioned that the move would do little because they say fear that interest rates is not the real problem in the economy. They say that the move could make consumers more nervous. Greater uncertainty is currently inhibiting spending, production and employment. Even if a rate cut does materialize, some Fed officials and economists are worried that lower rates would do little to dispel uncertainty stemming from the prospect of a US war with Iraq and restraint on business spending Analysts are also wary of pinning too many hopes on Fed policy when the US economy is struggling to carry global growth with little help from Europe and Japan.

N Janardhan Rao

BPO: Sustaining the Competitive Advantage

The Business Process Outsourcing (BPO) sector is making waves in the Indian industrial landscape It is dubbed as one of the most happening sectors after the IT boom that swept across the country for over a decade. The Nasscom and McKinsey report, which is extremely optimistic about the prospects of BPO in India has further heightened the enthusiasm about the industry. BPO *per se* goes beyond the realms of traditional outsourcing. Traditionally, outsourcing has been limited to supplying some specific goods, but when it comes to business processes, the demands are different. A BPO provider has to work in close association with the client. All the more so when services include direct interface with the customer. The company going in for outsourcing cannot rest once having transferred the process. In order to ensure quality it has to keenly monitor the performance of the BPO provider since it would have a direct impact on the company's image. While non-core processes are outsourced thus freeing the firm's time and resources for core competencies, BPO creates an extended form of organization The changing business form also demands changing control mechanism and management practices.

India is one of the most preferred destinations for outsourcing business processes. The reasons are many: Large talent pool of English-speaking, college educated youth who are willing to make a career in BPO, the cost differential, the strategic location with its time difference, the generally favorable government attitude towards BPO, the brand name India has achieved in its software industry and finally the quality standards. Lured by the possibilities, many MNCs such as GE, HSBC, Citigroup, Dell etc., have established captive centers in the country way back in mid-1990s. The industry also boasts of a number of pure play BPO providers who are competing to make a presence in the sector. More recently, software majors including Infosys and Wipro have made a foray into the industry.

The general economic recession has further forced companies to explore ways and means to cut corners and minimize costs. In such a scenario India comes out as a ready destination for BPO. However, there are a number of factors that India needs to keep in mind if it wants to retain the status of a preferred destination. Infrastructure in the country is improving but is still far behind many other countries. The cost differential which is presently India's USP would not last long since there are other cheaper destinations in the fray. As they go ahead, Indian companies need to keep in mind that quality of service, delivery as per the client's requirements and moving up the value chain could be the determinants.

D G Prasuna

Letters to the Editor

Congratulations

The annual special issue of *Analyst* was a reader's delight. The variety of topics covered in the magazine as well as the profile of the authors was very good. I congratulate the *Analyst* team for bringing this issue which can be treasured by the readers

Ramana Murthy
Guntur

Booming Biotechnology

The special issue of the *Analyst* made a very interesting reading. The highlight of the magazine was the section on the prospects of various industrial sectors. I found them very enlightening The articles on biotechnology were really enlightening. In my opinion India has the right knowledge pool, which should be instrumental in the further growth of this sector.

Sravan Prasad
Mangalore

Financial Markets at an All Time Low

The financial markets across the globe are at pretty low levels. Across the globe, investors are staying away from the market thus dampening the volumes much more. The comments on financial markets in the special issue of the *Analyst* brought out a number of finer details about the markets

Praveen Kumar
Hyderabad

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CHARTERED FINANCIAL
ANALYST

Cartoon Corner

YOU SAID IT by Laxman

You can't trust anyone! He has given fake notes as bribe, has he? You must sue him and drag him to court!

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Verbatim

It's a kind of wake-up call for everybody about the necessity of transparency. It will be dealt with—if not now, then in the next six months.

Carlos Ghosn, President and Chief Executive, Nissan on the failure of corporate governance in US.

Economists are always predicting a recovery. We are condemned to expect a recovery. But the coming year could still be difficult.

Eric Chaney, Economist, Morgan Stanley, London on global economic rebound

China has the condition and position to play a more active role in the outsourcing market.

Yu Youjun, Shenzhen's Mayor, on promoting the city as an IT

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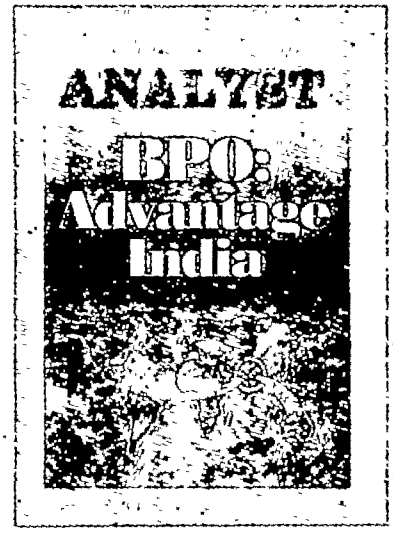

Cover design by M L Anand Rao

BPO: Advantage India 19

Driven by cost advantages and competitive pressures many companies are now looking for specialized service providers to whom they can outsource their non-core but necessary business processes. Technological advances have made distance a redundant concern. In such a scenario, India with its cost differential, educated workforce and quality of service, is fast emerging as a preferred destination. Business Process Outsourcing or IT-enabled services, as it is called, is emerging as the next big opportunity for India.

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Mergers in banking sector are again gaining momentum with the proposed mergers of PNB and Andhra Bank with Nedungadi Bank and Centurion Bank respectively. Small time players have no other option than to look for merger partners as they are finding it difficult to sustain their growth.

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IMF concerns

International Monetary Fund had expressed concern about sustainability of India's fiscal situation and debt position. However, it highlighted the improvement in poverty, low inflation, substantial reduction in external vulnerability and progress in strengthening the financial sector. On the other hand, during the first quarter of 2002-03, the Central Statistical Organization (CSO) estimates that GDP grew by 6%, as against 3.5% during the corresponding period in the previous year. RBI has projected the GDP growth for 2002-03 in the range of 5-5.5%.

On the growth path

India's industry chamber, CII's 58th Business Outlook Survey, conducted bi-annually, has revealed that the business confidence that had strengthened during the beginning of the year has not weakened despite the weak monsoons and the prevailing uncertainty in the global economy. Industrial growth would continue to trend upwards in the second half of the current fiscal according to a majority of the respondents of the Survey. Fifty-one percent of the respondents stated that general business prospects for their company would improve over the next six months. While 41% of the respondents felt that the same trends would continue, only 8% felt that they would experience a worsening in the general business prospects for their company. Sectorial analysis revealed that the capital goods and intermediate goods sectors would exhibit higher growth in the next six months. The fresh investments would be largely fed by the expectations of a pick-up in both domestic and international demand.

The Integra advantage

The Mumbai-based Miles Software has developed a comprehensive system, MoneyWare Integra, that offers the flexibility to account for a full spectrum of funds and securities holdings, with added power of rich tracking and reporting tools. It is a multi-currency professional portfolio management system, which can be configured as a funds management system that manages a series of portfolios that constitutes a Fund. This option provides full investment accounting, real time financial statement and user trade date accounting. This new technology allows for greater productivity due to an intuitive windows-based interface that allows true multi-tasking capabilities.

India: IT stronghold

According to PricewaterhouseCoopers, India's position in the global software service sector is very strong with Israel and Ireland, the only two countries who can give India a run for its money, still struggling to gather a critical mass. Says Rajarshi Sengupta, partner (technology practice), PwC, China, which is projected to cause a major threat to India's position in the global software services and IT-enabled services area, is far behind due to its lack of capability in English. The biggest advantage that India has over China is the language. In areas like embedded software and hardware, where language is not an issue China will pose a threat to India.

Outsourcing blues

Indian software services companies, better watch out. For, 15% of the *Fortune* 500 companies in the US which have outsourced projects to India are now looking at new locations in order to reduce their dependence on just one country for their IT requirements. Michael R Taylor, an industry expert says, "Many of the *Fortune* 500 companies are now looking at ways and means of hedging their bets and diversifying risks in outsourcing. They are looking at other locations, including China, the Philippines, and Vietnam, key locations at the moment." The calculations have been made by NeoIT, one of the leading international outsourcing consultancy firms, representing major US and European multinationals. Taylor pointed out that while India had a 90% market share of the offshore business in the US, this would decline in the next few years. One reason is geopolitical.

Multinational companies do want to hedge their bets on one country so that in the case of international political uncertainties (like an Indo-Pak war) or domestic problems (like the riots in Gujarat), they can shift to other locations. Also, new markets like South Africa and Latin American countries have the advantage of being in time-zones much closer to that of the US than India, a major advantage in the IT business. There are too many IT services companies in India and it is difficult to differentiate one from the other because all of them are focused on price, rather than quality or any other criteria. So there is an imminent need for consolidation.

Emerging as a global engine

China's economy has defied the worldwide slowdown and continued its long streak of rapid growth, raising the prospect that it has begun to pull its weight as an economic engine for Asia and for the world. With the US, Europe and Japan all experiencing sluggish growth, China's economy is expected to expand by a robust 8% this year, fueled by a surge in exports, soaring foreign investment and a housing boom. Even if its growth cools next year, as most economists predict, China has begun to rival Japan as the pivotal player in the Asian economy. China has become the largest export market for both South Korea and Taiwan, for example, and has elbowed out Japan to become the biggest Asian exporter to the US. In size, the Chinese economy remains far behind those of Japan and the US. Chinese output is about one-quarter of Japan's and one-ninth that of the US. However, experts say even if China continues to grow much more quickly than the others, it will be the middle of the century before China becomes the world's largest economy.

Sluggish growth

The global economic outlook looks sluggish impeding poverty reduction in developing countries, but South Asia will achieve an average of 5.4% growth in 2003 and it will grow at an average growth rate of 5.8% in 2004, according to a new World Bank report Global Economic Prospects and the Developing Countries: Investing to Unlock Global Opportunities. Growth in the region is expected to average 4.6% for the year, a downward revision from the "Global Economic Prospects 2002" forecast of 5.3% GDP growth. Uncertainties in global financial markets have sapped the momentum of the modest recovery that began in late 2001.

After exceptionally slow growth in 2001 and 2002, global GDP is now expected to rise by 2.5% in 2003, higher than the previous two years but still well below the 3.9% expansion recorded in 2000 and significantly below long-term potential growth rates. The report warns that the global rebound might quickly lose momentum and there was significant risk that the world could slip back into recession.

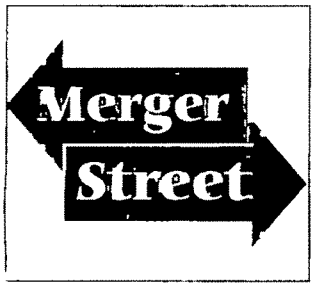
The future means getting personal

While everyone has declared that the dotcoms are dead, it is not clear to me that the revolution they started is dead, says the leading global consultant, Prof. C K Prahalad. Coming from almost anyone else, it would be difficult to keep a straight face. Post-bubble wisdom holds that there was nothing revolutionary about the multi-billion-dollar blowout of the dotcom era. It was one of the touchstones of the dotcom era that the Internet would empower consumers by giving them unprecedented access to information and the ability to shop around. This has indeed happened, in markets ranging from air travel to health care. Prof. Prahalad contends that (a) the trend has only just begun and (b) it has profound implications for the kind of corporate strategies required to create lasting competitive advantage. He explains, "The assumption has been that consumers will extract value by negotiating harder—and to some extent this is undoubtedly true. But consumers can also help create value. Co-creation of value becomes a premise of the emerging economy." The common thread is that these companies are trying to engage with customers, open their doors and their processes and tap into that quivering mass of *ad hoc* communities known as the Internet.

Monetary union challenges

If one were to judge Europe's fledgling monetary union by its ability to generate economic growth in member countries, one would have to judge it a keen disappointment. The fastest-growing large economy in Europe is Britain. It so far has refused to adopt the euro, the common currency shared by 12 countries, preferring the pound instead. Germany, the anchor of the euro-zone and home of the European Central Bank, is the Continent's economic laggard, with growth for next year projected at barely 1%. Defenders of the euro warn against drawing too many conclusions from this comparison. Germany, and to a lesser extent France and Italy, have structural problems in their labor markets and welfare systems that Britain tackled two decades ago during the free-market revolution of Margaret Thatcher. While German leaders seem paralyzed by their country's woes, France has made recent strides in shaking loose its corporate sector, emerging as a modest beacon in Europe's gray economic landscape. The architects of the EU may nurture ambitions to build the largest economic bloc in the world. But for now at least, Europe remains dependent on the US to lift it out of its sluggishness.

N Janardhan Rao



French banks discuss merger

French bank Credit Agricole offered to shell out $16.43 bn to take full control of Credit Lyonnais, in a deal which would create one of the largest financial institutions in Europe. Credit Agricole currently owns 17.4% of Credit Lyonnais. Its offer of € 56 ($57.10) a share values Credit Lyonnais, France's fourth largest bank, at $19.92 bn. Analysts believe that the deal would be good for Agricole, since Lyonnais makes a good strategic fit. Credit Agricole has been Credit Lyonnais' largest shareholder for more than three years. As a part of the deal, Credit Agricole will acquire the remaining 288.1 million shares, or 82.2%, in Credit Lyonnaise. Shareholders are offered €148.24 ($150.95) in cash, plus five newly issued Agricole shares for every Lyonnais share held.

The announcement of the deal marks the end of the four-week tussle between Credit Agricole and rival suitor BNP Paribas for the control of Lyonnais, which is France's fourth largest bank. If it happens, the merger of the two banks would create a financial institution with more than €33 bn ($32.4 bn) in market value—and a 28% share of France's retail banking.

GE in a €2 bn deal

General Electric, the US industrial and financial group agreed to buy Instrumentarium, a Finnish medical equipment group for €2 bn ($2.06 bn) in a move aimed at expanding its medical unit.

As per company sources at the Finnish group GE will offer €40 per share. The deal, expected to close in 2003, needs 80% approval from Instrumentarium shareholders and regulatory approval. Company sources maintain that, "Upon completion of the tender offer, GE intends to combine the operations of Instrumentarium with GE Medical Systems, and Helsinki will become the European headquarters for the GE Medical Systems' business." Speaking on the occasion Jeffery Immelt, the Chairman and Chief Executive of GE, said that it is an extremely important business for GE, and we plan to grow Instrumentarium even further by investing in new technologies to improve clinical workflow, physician confidence, and patient outcomes. He further told analysts that Europe was one area where GE, was planning 'very substantial' growth.

The Finnish group operates in anesthesia critical care and medical equipment. It sold its small optical retail operations in November. Anesthesia and critical care is its key division, accounting for 70% of sales last year. This division also produces equipment and monitoring systems for intensive care areas in hospitals. To get into the US critical care market, Instrumentarium, earlier this year, spent €142 mn on a US company called Spacelabs Medical. It now generates more than half its sales in the US. Spacelabs is expected to show a positive operating result in the final quarter of this year and is regarded as a key driver of group growth. Even without Spacelabs, the group reported organic sales growth in the US of 12% in the first nine months. In June, GE Capital revealed plans to establish a dedicated mergers and acquisitions team to target struggling industrial groups in Europe.

Vivendi sells stake in EchoStar

Vivendi Universal's short-lived entry into the US satellite television business ended when the troubled French media group sold its shareholding in EchoStar for $ 1.06 bn, which is a loss of almost $500 mn. EchoStar is buying back the 10% shareholding from Vivendi for just $1.06 bn— compared with the $1.5 bn that Jean-Marie Messier, Vivendi's former chief executive, agreed to pay for the stake exactly a year ago. The sale is the latest step by Jean-Réné Fourtou, Chief Executive, to unwind the rash of deals made by the former chief and is another important step in reducing the company's indebtedness. EchoStar is buying the shares for $18.50 each, 29% lower than the $26.04 valuation Vivendi attached to EchoStar's stock last year. By selling now, Vivendi is also walking away from a possible $525 mn pay-out from EchoStar. At the time of the deal, EchoStar gave Vivendi contingent value rights in case the US group's shares lost value. But Vivendi concluded it made more sense to sell the stake now than wait for the payment, which it would not have received until mid-2005.

EchoStar investors welcomed the deal, which removes a potential overhang of stock from the market. Vivendi had been expected to sell the stake once EchoStar abandoned its plan to merge with Hughes Electronics, owner of its main US rival, DirecTV. Investors and rating agencies had criticized Messier for paying a premium to buy a minority stake in an illiquid asset that was subject to lock-up clauses relating to the DirecTV merger.

The new CEO is also in the process of extricating Vivendi Universal from the web of constraints Messier put in place at the time of his $13 bn acquisition of the

media assets of Universal Studios from Barry Diller. Vivendi Universal is looking to sell or float the other US entertainment assets acquired by Messier. Last week General Motors, which owns Hughes Electronics, released EchoStar from an obligation to buy Hughes' 81% stake in Panamsat, the satellite operator, for $2.7 bn.

CSC to buy Dyncorp

Computer Sciences Corporation (CSC) and DynCorp have entered into a merger agreement providing for the acquisition of DynCorp by CSC. The transaction is valued at approximately $950 mn, including the assumption of all of DynCorp's debt, which was $273 mn of principal amount on September 26, 2002. After the merger, each DynCorp share will be converted into $15 in cash and $43 in market value of CSC shares.

The transaction requires approval by the holders of a majority of the approximately 11 million outstanding DynCorp shares and is subject to customary conditions, including expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act.

The terms of the acquisition have been approved unanimously by the boards of directors of both companies. The deal is expected to conclude during the first calendar quarter of 2003, and CSC expects the acquisition to be accretive to earnings for fiscal 2004 excluding the impact of a special charge related to the transaction.

DynCorp, with revenues of $2.3 bn in the last fiscal is among the largest employee-owned information technology and outsourcing firms headquartered in the US. The company, which employs more than 23,000 technology and technical professionals at more than 550 locations globally, focuses on the large defense, security and civil markets. Services include systems and network integration, high-tech range operations, global defense logistics and maintenance services and contingency support, homeland security services, and infrastructure management of critical defense assets.

DynCorp will become part of CSC's Federal Sector unit, which currently has approximately 15,000 employees and is headquartered in Falls Church, Va. The combined organizations will provide significantly greater scale to CSC's presence in the US federal marketplace. When the acquisition is completed, CSC will derive approximately $6 bn in annual revenue from the Federal Government (based upon estimated fiscal 2003 year-end revenues) and have nearly 38,000 people serving the US Government globally.

AmeriPath accepts buyout

AmeriPath®

AmeriPath Inc., a cancer diagnostic services provider, announced its acceptance of a $627 mn takeover bid from Welsh Carson Anderson & Stowe, a private buyout firm moving to expand its health, care holdings. Welsh Carson, which already owns 4 9% of AmeriPath, would pay $21.25 per share for the remaining stock, which values the deal at about $627 mn based on AmeriPath's 31 million outstanding shares on October 29. The agreement allows AmeriPath to seek other buyout proposals until December 21. If the deal were terminated, the company would have to pay Welsh Carson a $12.9 mn break-up fee.

Welsh Carson would also assume about $172 mn of AmeriPath's debt and other obligations. AmeriPath's cancer diagnostics services include the Center for Advanced Diagnostics, which provides specialized cancer testing and genomic research. The company also gives clinical trial support to companies developing new cancer and genomic diagnostics and therapies. Welsh Carson, one of the largest private equity firms in the United States, invests in health care, information-services, and communications companies.

Omnicare buys NCS HealthCare

Omnicare Inc. is all set to buy pharmaceutical services provider NCS HealthCare, the fourth largest institutional pharmacy provider in the United States, for $5.50 per share in cash and the repayment of NCS debt in a transaction with an enterprise value of approximately $460 mn. The transaction was unanimously approved by the boards of directors of both Omnicare and NCS.

The firms primarily serve individuals in long-term care facilities. The transaction will improve Omnicare's position as a leading provider of pharmacy services for the elderly by combining NCS's approximately 199,000 residents served with the approximately 746,000 residents already served by Omnicare.

The combined company will have a nationwide network of pharmacies serving long-term care providers in 47 states of the US. The deal is expected to close early in the first quarter of 2003 and be accretive to Omnicare's earnings per share beginning in 2003. Under the terms of the merger agreement, Omnicare will amend its outstanding tender offer for all of the outstanding shares of NCS on or about December 23, 2002 to reflect the terms of the agreement.

D G Prasuna

CAPITAL ACCOUNT CONVERTIBILITY

Is India ready?

The Reserve Bank of India has been relaxing foreign exchange norms across various market segments. Will this pave the way for more openness on the capital front?

A couple of months ago the Reserve Bank of India had announced a scheme wherein resident Indians were allowed to maintain a foreign currency account known as 'Resident Foreign Currency (Domestic) Account'. Thus, resident Indians can hold foreign exchange in excess of $2,000, denominated in any foreign currency, in this account. However, only those foreign currencies/travelers cheques would be allowed to be retained in this account that are acquired from specified sources mentioned by RBI.

The Central Bank has not placed any overall limit on the amount held in these accounts as long as the money is obtained from permissible channels. These accounts will be non-interest bearing and will be in the form of a current account with cheque facility. The balance in these accounts can be used for any permissible purpose under the foreign exchange regulations for domestic Indians such as medical treatment abroad, gifts up to $5,000, education abroad or purchase of books (directly or through Internet). Prior to this, resident Indians were permitted to retain up to $2000 or its equivalent either in cash and/or travelers cheques. The new scheme is in addition to this.

The move by RBI has once again brought to fore the perennial debate on capital account convertibility. Most of the market players do see this move as a step closer to opening the Indian economy on the capital front. But is it really so?

Apparently not. "This (move) only indicates that all is well with us as far as balance of payments is concerned and RBI believes that it need not hold reins stringently. Since the current (forex) reserves are definitely more than what is needed, (the RBI) wants to make it available to people for investment on individual accounts," says GRK Murty, Consultant, ICFAI.

In other words, this is a tacit admission by the RBI that as long as things move as contemplated, there is nothing to worry about. Short of announcing convertibility, the Central Bank is letting people enjoy that benefit by piece-meal relaxations as the situation would encourage it. And if the wind blows against it, it can always withdraw the relaxations and exercise its fiat as it has been doing all along, ever since the exchange rates became market determined. If the RBI perceives the situation to be favorable enough to warrant substantial relaxations, then why does it not allow the rupee to be convertible on the capital account? The primary reason is that if the RBI explicitly announces a convertibility, there will be little it can do if things go wrong other than being a mute spectator. Secondly, the Indian economy is not really geared up for an 'explicit' Capital Account Convertibility (CAC). Although the foreign exchange reserves at $67 bn seem to be adequate, inflation remains within the 3-4% band and substantial improvement has taken place in terms of consolidation in the financial sector, the economy is still way behind the minimum requirements for CAC as defined by the Tarapore Committee in 1997. Banks are still saddled with a high level of NPAs, the current deficit does not really seem to be manageable and the financial sector still requires to be strengthened.

The protagonists of CAC cite the strong foreign exchange reserves as being sufficient for India to open up on the capital front. Unfortunately, one only needs to look at the break-up of the foreign exchange reserves to understand that most of the foreign currency flowing into India is only for arbitraging the interest rate differential between our country and the US. Trade flows are really restricted to exporter and importer requirements, unlike in China where FDI accounts for most of the foreign exchange reserves, which stood at $259 bn at the end of September 2002 (excluding Hong Kong). As Murty puts it, "There is nothing to gloat about the reserves of $67 bn. It can melt any day, should something turn against us."

So, what if India does go in for CAC today? "It is shuddering to think of the consequences, to be very honest," admits Murty. None can deny the fact of the parallel economy performing in the country. And given a chance, the Indian rich would undoubtedly carry all their money into the western capital markets, where the returns are more sustainable than in the Indian markets. And with declining savings rate, any movement of domestic funds to overseas markets will have an adverse impact on domestic investment. So, what is to be done? Says Murty, "What matters is neither convertibility or non-convertibility. What matters is the investment climate in the country. If that is made good, there is no reason why we cannot attract as much FDI as China is doing."

Let us clean our domestic investment climate then, before we even think of CAC

E Kalyan Babu

Reference # 1-2003-01-01

WALL STREET RESEARCH

Will it survive?

The past year has been worrisome in the history of Wall Street research. After the conflicts, investigations, settlements and new regulations, will it regain the repute that it once enjoyed?

Wall Street is in disgrace. Not so much for pumping up the technology bubble or for the role in the financial shenanigans at Enron, WorldCom and the like, but more for the well chronicled misdeeds of securities analysts and investment bankers. New York State's district attorney, Eliot Spitzer, is leading investigations into individual firms—an exercise that is fast turning into a cross-examination of the entire industry. The various inquiries stem from concern that investment bankers at Wall Street firms, especially during the bull market, pushed stock analysts to slant their research on companies that were generating millions of dollars in investment banking fees.

The issue of tainted Wall Street research became front-page news earlier this year when Spitzer's office produced a series of damaging Merrill Lynch internal e-mails that Henry Blodget, once an analyst with Merrill, was revealed to have been describing the same stocks that he was puffing to investors as 'junk' and 'crap'. Merrill later agreed to settle that investigation by paying a $100 mn fine and agreeing to changes in its research practices. But that was only the beginning of the banks' atonement, a worrying process whose end still seems a long way off.

Since the Merrill investigation, more damaging information has come out about Wall Street's business practices. And the firm taking much of the heat these past few months has been Citigroup. Citigroup's chief telecom-research analyst, Jack Grubman, supposedly objective, appears to have been positive about WorldCom and other telecom companies in his reports in order to generate investment banking business. Grubman's $20 mn-a-year compensation was based in large part on the amount of investment banking fees he brought to Citigroup. And New York State Attorney General Eliot Spitzer is looking into whether Citigroup Chairman Sanford I Weill leaned on Grubman to change his rating of AT&T (Weill is on the board). Soon after Grubman upgraded it from 'neutral' to 'buy', AT&T gave Citigroup's Salomon Smith Barney an extremely lucrative underwriting assignment. Coincidence? Tough to believe!

There is also much speculation, and some e-mail evidence suggesting that Grubman had upgraded his rating of AT&T in early 2000 to persuade Michael Armstrong, AT&T's chief executive and a board member of Citigroup, to back Sanford Weill in his (successful) attempt to oust John Reed as his fellow-boss at Citi in exchange for help in getting Grubman's children into a nursery school, with the support of a $1 mn Citigroup donation to the school.

Conflicts of interests like these have been a big issue in the investment banking business. The so-called Chinese wall that is supposed to prevent conflicts of interest between the two sides of an investment bank has been an ongoing joke for years. Today, the wall is hopelessly porous. The main problem as Richard S Shreve, Professor of finance, Tuck School of Business Administration at Dartmouth College points out, "the reason why we're in the soup is because some analysts were telling customers one thing but were actually believing something else." Most banks, like Merrill Lynch, have internal policies that demand that analysts be impartial, but then they would compensate those analysts based on specific investment banking deals in which

they have been involved. In a "best practices seminar", Citi's analysts were taught to support underwriting by providing companies that had just gone public with estimates of earnings so low that the companies could easily exceed them in the following two quarters.

In 1990s, favorable coverage by a friendly analyst became part of the suite of services that investment bankers offered corporate clients. And the rise of celebrity analysts duped gullible investors, who believed that they were getting reliable information from their television. The stage was set for abuses by Grubman and others.

In the opaque financial world of conflicts and synergy, hot IPO paper, lucrative underwriting deals, deal-hungry bankers and analysts' opinions for fee-based investment business, investors were left holding the bag. Much of the abuse and bad behavior is being corrected though slowly, as a host of changes, minor and major, are demanded by investors and are required by regulators and also voluntarily by few firms that are anxious to appear squeaky clean. But will any of this help Wall Street research to restore its good name or is its reputation too far gone to bother?

Research soon became as much as a promotional tool for bankers and their corporate clients as it was a source for unbiased intelligence for investors

The conflict-of-interest minefield

Modern Wall Street research started in 1959 with offering of stock research reports to the investment management companies and corporate pension funds that were beginning to dominate the market. Analysts would provide these buy-side customers with a level of depth and insight that these investors could not attain by themselves. The research firms more than offset the cost by asking customers to pay them back with orders sent to their trading desk.

Research wasn't tainted then. But when NYSE deregulated fixed commissions on stock trades on May 1, 1975, commissions touched rock bottom levels and research became a money loser. Research required a new trough to feed, and investment bankers provided it by subsidizing it with revenues from their lucrative underwriting business. Soon research departments were beginning to rely more on corporate finance. They were cooperating more closely with banking divisions on mergers and acquisitions, IPO roadshows and investment banking deals. Research soon became as much as a promotional tool for bankers and their corporate clients as it was a source for unbiased intelligence for investors.

Then the changes and reforms during the last two decades-discount brokerages in 1980s, online trading and the advent of decimalization in trading in 1990s—created relentless pressure for firms to lower transaction costs. And it became impossible to pay analysts out of feeble trading commissions. Instead, they were compensated for securing an IPO client based on the underwriting fees or sometimes for doing very lucrative merger-and-acquisition deals. This made the analysts much more interested in pleasing the client, as opposed to the long-term user of the research, the investor. Today, research budgets at major brokerage firms range from $500 mn to $1 bn. It was the need to meet these budgets that put independent judgment into murkiness.

But one interesting observation to note is that virtually no one who mattered in the investment industry—i.e., portfolio managers at large pension, mutual and hedge funds—ever took analysts seriously.

> **"The reason why we're in the soup is because some analysts were telling customers one thing but were actually believing something else."**
>
> **Richard S Shreve**
> *Professor of Finance*
> *Tuck School of*
> *Business Administration*

Only the public did. If they were called 'promoters' rather than 'analysts', the public would have had a better idea of their role in the retail investment ecosystem. The real purpose of research on the Wall Street has always been to provide a veneer of intellectual respectability to a sales endeavor.

In the heady days of the bull market, no one minded these conflicts, because all were making money. Practices and business ethics deteriorated dramatically during the period, and it is now proving difficult to restore them. Burst of the stock market bubble, economic gloom, corporate scandals wave and alleged analyst misconduct changed everything. As the queries intensified and threat of criminal charges grew more real, individual firms began to act on their own. CSFB, JP Morgan and Salomon Smith Barney voluntarily adopted reforms called under Merrill's settlement. There is review of analysts' compensation methods and also on their involvement in IPO process. Citigroup separated research arm and other investment firms have taken less drastic steps so far to return analysts to their traditional role—and not just to attract investment banking business.

Future of research

While the industry is moving decisively, burnt investors, eager

prosecutors and aggressive regulators are not willing to leave things at that. They are seeking not just punishment for wrongdoers but comprehensive reforms of the industry's structure. Everyone wants a simultaneous, industry-wide solution that would put a stop to further investigations. The real debate now is whether to impose a separation of research analysis from the rest of investment banking.

Though it is unclear what form such a split will take, there is this belief, which everybody buys into, that one can't have great research if it is attached to investment banking. Jay R Ritter, Professor of Finance, University of Florida says "as long as research is under the same roof as investment banking, there will be conflicts of interest. 'Rainmakers' get rewarded, there will be an incentive to give bullish recommendations as long as it helps bring in corporate finance business." The source of most of the conflicts of interests are not subtle points—they are, rather, open and notorious. And it is believed that as long as research exists on the same P&L as banking, it is difficult to get rid of the conflicts. With higher Chinese walls it would be just less blatant.

However, lopping off research from the rest of investment banking firms is not a good idea, either in theory or in practice. A full-service bank has a corporate finance department, a trading department, an institutional salesforce, and a retail salesforce. One analyst team serves all of those groups. They screen investment-bank deals and provide content and ideas to the institutional and retail sides. One of the advantages with having research in a full-service investment bank is having a cost structure that helps to leverage on the banking side and also on the investor side, so the investors don't have to pay for it themselves. One can make the research 100% credible with the public through a complete separation, but it would make it less useful for the rest of the bank.

But with everyone talking about separation as a forgone conclusion, the possibility is that the research departments will become distinct subsidiaries of Wall Street firms. Then the research units will be left with two options to fund themselves: Direct contributions from the brokerage operations they support (though there are conflicts between trading and research, they aren't as blatant) or annual budget allocations from the parent company. In the first case, lack of investment banking subsidization means dramatically less research budgets. In the second, research firms' managers will fight for the budgets without knowing clearly the value of the research to their firms and would be chaotic. Citigroup is trying out the idea of creating a separate equity research company that would be supported by the bank's general revenue. Many regard it a mere negotiating tactic but not an end to conflicts.

One can make the research 100% credible with the public through a complete separation, but it would make it less useful for the rest of the bank

No matter which model Wall Street adopts, few things are inevitable. First, it means fewer and far less-paid analysts and less research. Second, because there is little trading volume in most small- and mid-cap stocks and most mid-cap coverage is almost entirely supported by investment banking, majority of analysts will focus exclusively on large caps and will drop coverage of small companies. Also, it's likely that research departments will look a lot more like the backwaters they were before 1975. Ritter says, "Even the 'independent' research faces conflicts, even without underwriting revenue. Main institutional clients who seek research are those who are long in the stock and they would not like an analyst to downgrade the stock. And another problem is that the analysts who are bullish will get preferential treatment from firms when it comes to returning phone calls etc."

"One definite change that would occur would be that analysts would go back to being more analytical and less 'cheerleaders'.

Jay R Ritter
Professor of Finance
University of Florida

There are also serious competitive implications for the Wall Street. The economic model for equity research has just two revenue streams—retail and institutional clients and with anemic commissions from them, research cannot stand on its own economically. And firms that rely more on institutional clients will have tougher time. On the face of it, firms like Salomon, Merrill and Morgan Stanley may be able to better cope with the new economics of research, thanks to their strong retail brokerage operations where as Lehman Brothers and Goldman Sachs that primarily serve institutional brokerage clients will find it tough to compete.

The economics of research as a business model are notoriously tricky; the notion of selling research is virtually never done for hard dollars. However, there are already a few boutique firms that have made money with such a model, and more are springing up as big-bank research has been

discredited. Few foresee the rise of paid-for research, in which investors subscribe to research reports from independent or buy-side analysts who are widely considered to be far more impartial because they have no investment banking. In fact, paid-research firms and websites have proliferated in the past few months as many money managers and hedge funds are ready to pay value for that independence. But these firms face lot of obstacles. Most firms are small, covering 10 to 20 stocks compared to 500 or 1000 that a sell-side firm might cover. They cannot offer the execution efficiency at the trading desks that their giant counterparts offer and attracting and retaining talent is a major challenge. It has been a cottage industry and these small shops will face the same economic limitations that forced the original research boutiques to spread their costs over a wider revenue base. Most important limitation is how many such boutiques can Wall Street support

Solution in sight?

Regulators and bankers have been hammering out a deal to end probes of allegations Besides fines to be imposed on the banks, another key aspect of the settlement talks apart from separating research is to set up a research consortium. Under the draft agreement, large investment banks would cough up to $1 bn over five years to establish a new industry-wide stock research panel. This panel would, in turn, hire independent companies to generate analyst reports for small investors, which the big brokers would distribute alongside any proprietary research they still wished to conduct. Shreve opines that it would not eradicate the conflict, but may help retail investors, as it is indeed retail, not institutional investors that currently needed protection.

The $1 bn panel, in fact, seems a cheap way for Wall Street's giants to put a thorny problem behind them, (specially when compared with the money they made in bull market days). Though it sounds like a boon for individual investors, it's only a partial solution. Many independent research houses have lucrative contracts with institutional investors; which pay handsomely for exclusive access and they wouldn't like to drop such contracts. And whether this independent entity will give quality information to investors will be known only after seeing exactly what kind of research will be offered.

But either the $1 bn panel or any jerry-rigged restructuring will not eliminate the long debated conflicts. The real problem is the system by which brokerage clients pay for research on Wall Street. Rarely does a retail client ever pool up cash for an analyst's opinion; instead, research is provided as a sweetener to customers of brokerages. While there are many pure-play research firms that charge for the analysis, major Wall Street firms would have difficulty charging money for information that their clients previously had received for free. So, making research truly independent and responsive to customers would require a significant change in the structure of the business and, as importantly, in the mindset of individual investors. And it would probably mean investors would pay far more than they're accustomed to.

It won't be new rules that will fix Wall Street. Chinese walls, however high, are always likely to fall at the first assault from deal-hungry bankers

Many banks have already done a lot to address the public criticism, in the belief that there is now a competitive advantage in offering more transparency and greater integrity than other firms. Changes at a handful of firms are putting pressure on other firms to change. And all the firms are trying to distinguish their research from everyone else. Ritter feels that one definite change that would occur would be that analysts would go back to being more analytical and less 'cheerleaders'.

But the regulators aren't so sure that the industry will willingly make changes to the way it does business. Even if the research is not separated, still more rules and regulations are all but certain. But in the end, it won't be new rules that will fix what's wrong with Wall Street research. Chinese walls, however high, are always likely to fall at the first assault from deal-hungry bankers. It would be wiser for investors and issuers always to act on the assumption that conflicts exist. The market itself provides plenty of sanctions against wrongdoers: The loss of customers; tattered reputation, downgrades by credit-rating agencies; and punishment of the share price. The latest crash has already cleaned up most of Wall Street's excesses—that is how markets work. The main danger is that there may be overregulation to solve a problem that the marketplace can solve on its own, as it will be self-correcting. The real challenge is to establish a climate where good analysts are rewarded by investors and poor analysts are punished.

Whatever path research takes, the goal is to restore investor confidence and trust. For this to happen, regulators, investment bankers and other interested parties should try to create a new system for producing, delivering and paying for the kind of in-depth research that, Wall Street created more than four decades ago. Without such a solution, Wall Street research may survive but its integrity would be in doubt forever.

A Sowdeepti

Reference # 1-2003-01-02

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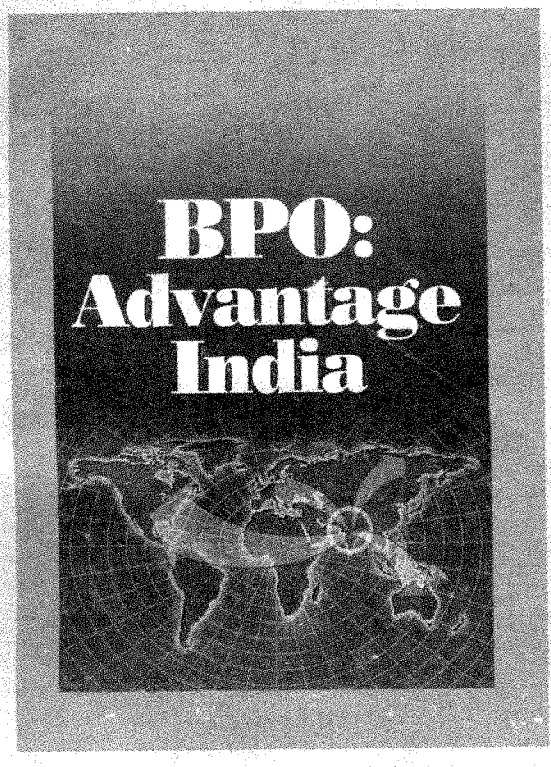


Driven by cost advantages and competitive pressures many companies are now looking for specialized service providers to whom they can outsource their non-core but necessary business processes. Technological advances have made distance a redundant concern. In such a scenario, India with its cost differential, educated workforce and quality of service, is fast emerging as a preferred destination.

Business Process Outsourcing or IT-enabled services, as it is called, is emerging as the next big opportunity for India.

BPO: Advantage India

Business Process Outsourcing (BPO) is the latest phenomena to grip India. After the sweet success in the field of Information Technology (IT), India now dreams of becoming the most preferred destination for BPO ahead of countries such as Philippines, Mexico and Ireland. The chances are it just might make it. The sheer magnitude of the BPO opportunity is tempting. The global BPO market as per the Gartner Group grew by 13% between 1999 and 2000. Further Gartner predicts it to be $234 bn in 2005. India expects to garner a major chunk of this global pie. The predictions and projections for the potential of the BPO sector are very upbeat with the *Nasscom-McKinsey Report 2002*, scaling up the potential revenues from the sector by 2008 to $24 bn from the $17 bn it had projected in its 2000 report. Further the report claims that the IT-enabled services sector would account for 37% of the total IT software and services export market by 2008. In fact the shift towards ITES is already underway, with the sector steadily increasing its share in the overall IT software and services industry to 20% by 2001-2002 from a meager 6.5% in 1998-99.

Getting to the roots

"Manufacturing, distribution, accounting, whatever should be subjected to a simple test: 'could the output of each be sold on the open market?' If not, subcontract the work to the firms which specialize in each function which almost always certainly do it better and more cheaply."

- Tom Peters

Outsourcing is not a new concept. It has been in use since the turn of the 20th century, when Ford decided that instead of owning rubber plantations to produce its own tires it could simply outsource them. Outsourcing of manufacturing has been in vogue for long with many MNCs using cheap labor markets as the hub of manufacturing. But outsourcing of services is a fairly new phenomenon that has taken roots only in the mid-1990s and is gaining significance only now. The

facilitators for this are the changes in the business environment across the world. The increased pressures of globalization, severe competition, and the general slowdown in the global economies have forced companies to rethink their strategic positions. To remain profitable and retain competitive advantage, companies learnt the need to focus their energies both in terms of time and resources on core competence. Leaving the non-core business processes to specialized service providers not only minimizes costs but also improves the chances of the process being handled by experts.

The major breakthrough in technology, specifically in the field of communication, the Internet boom etc., have further made it possible for companies to think of the whole world as one market place and go offshore in order to build and sustain competitive advantage. Today it does not seem out of place for a company in US to outsource its business process to an offshore facility either in India or the Philippines or the Ireland because technology has made the relationship virtually hassle-free. The distance of thousands of miles does not matter since even at that distance it is possible to communicate, co-ordinate and control the operations. In addition there has been a fair amount of standardization of Web-based tools, which makes it easier to communicate and convey intentions clearly. Companies can critically examine each of their business process. Determine which are 'core' and which are 'not core' to the business of the company and seek the opportunities to outsource them in order to gain cost as well as competitive advantages. This newfound interest in business process outsourcing could prove to be a golden opportunity for India.

Welcome BPO

The BPO industry comes as a welcome opportunity for India. It could really be a shot in the arm for the Indian economy, with its export prospects, employment opportunities etc. Arun Natarajan, Partner, Arun Enterprises, a Chennai-based strategic consulting firm, comments, "...the emergence of the BPO industry has opened job opportunities to anyone with a college degree. (You might recall how less than two years back, the job opportunities in the IT industry were almost all reserved for technically qualified professionals —and that too especially for engineers.) If the boom in this industry lasts as projected by the Nasscom-McKinsey report, this trend—of "jobs for any college graduate who can speak decent English"—is bound to have a very significant impact on employment (and hence the economic) scenario."BPO is expected to provide employment to 1.1 million people by 2008 if Nasscom reports are anything to go by. The rise of the BPO sector could add jobs in the ancillary businesses as well including transport, catering, housekeeping, training etc. The contribution of the BPO segment to the country's GDP is expected to be around 3% by 2008. Arjun Vaznaik, COO, Tracmail says, "Currently, IT services is more than 10% of India's GDP and ITES is even smaller. If India is to grow the BPO opportunity substantially in the next four years to say 10 billion from two billion i.e., five times then this contribution could be as high as 15-20% which is substantial."

Country Competitiveness

Ireland	Philippines
• Historically, considered the leader in this space • A hub for pan-European shared services and Call Centers	• Sizeable presence in three areas – Call Centers – Medical Transcription – Animation
Singapore	**India**
• Significant presence in Back Office Processing for financial services companies	• Fast being recognized as the 'new' leader • Growing presence in multiple areas such as Call Centers and Back Office Processing • First country to see significant third-party activity

Source: Nasscom – McKinsey Report 2002

"IT and ITES services, as BPO is called today, are industries which has potential for immense growth over the short, medium and long-term, and would be blue-chip industries in times to come."

Krishan Dhawan
Chief Marketing Officer
Exlservice Inc.

India: The preferred destination

Ireland is an established player in the outsourcing segment. Philippines is also fast picking up. Other countries that are vying for a place in the BPO market are Mexico, Sri Lanka etc. But India is

niquely positioned both in terms the location attractiveness and ie workforce capability.

To begin with India boasts of a ch talent pool. India has the econd largest English-speaking eople with computer skills after ie US and with education being a riority in most Indian families this bound to rise in the future. There re 2.1 million graduates and 0.3 illion postgraduates passing out very year. The technical anpower pool of India is placed at .1 million. The number of ngineering graduates who pass out very year is around 2 lakh. The umbers no doubt are large but that s not all, there are other positive actors for BPOs. BPO, which does ot attract high caliber people in the JS, offers a lucrative job for the ndians mainly due to the higher alaries. As a result it attracts alented people, which invariably ranslates to better quality of the ork. The experience of World ank proves the point; World Bank oved its back-office operations to ndia from Washington in 2000. As result the bank's costs came own by 15%, in addition the bank lso reduced its backlog in accounts eceivables and expense forms. hat is not all, Indian accountants ave helped the bank get smarter, irtually reengineering the process ccording to sources at World Bank. nother advantage is in the lower ttrition rate. The attrition rate n India at somewhere between 12-35% is much lower than 70 to 120% in the call centers based in JS.

Cost-cutting is the oft-quoted reason for outsourcing. And in terms of costs India hold the promise. Positive cost differential was the attractiveness of Indian companies in the early days of software, the same goes with BPO too. A typical back office agent might charge anywhere between $2000 and $3000 a month in the US. It falls down to $200-$300 a month in India. On the whole the transfer of job to India might mean a cost savings of 30 to 40%, which should be all the more attractive during these recession years.

The third most important advantage is the state-of-the-art technology. In terms of technological advances and compatibility with the developed nations, India is second to none. Our IT industry had proved over the years that India can adapt fast with the pace of emerging technologies in the world scenario. The entry of the private players into the telecom sector has greatly increased the attractiveness of India as a BPO destination. Prakash Gurbaxani, CEO, TransWorks observes, "... on the telecom and infrastructure front, which used to be an area of concern, India has been making rapid progress. Removal of government control and privatization have led to the quality of services in these sectors becoming comparable to the best in the world and at the same time we are witnessing significant drop in telecom costs."

The Forecast (US $ bn)

	2001	2005	2008
Total Business Process Outsourcing market	127	234	310
Percentage offshored to countries such as India, Ireland, etc.	5%	15%	20%
Offshored BPO market	6.4	35.1	62
Indian ITES exports	1.5	9.5	21

Source: Nasscom – McKinsey Study 2002 and Gartner.

"There is bound to be some sort o consolidation in the industry. Today, there are a whole lot of players in the BPO/CRM space, it does not necessarily mean that all will be successful."

Prakash Gurbaxani
CEO
TransWorks

Another factor that has favored India in the BPO arena is the geographical location. India is ideally situated and the time differential, 12 hours ahead of the US provides a good opportunity for companies to provide a round-the-clock service to their customers. In fact, this is the emerging trend with most companies running operations on at least two shifts.

The role of government with reference to the IT-enabled services has been very supportive. In general, Indian Government's policies with regard to the software sector are encouraging. Many states have come out with a definite plan for sector. In all, 19 state governments have come out with definite IT policies. The IT Act 2000 which provides for a legal framework for the recognition of electronic contracts, prevention of computer crimes and accords stringent punishment is a big leap forward. There are 12 nations in the world that can boast of cyber laws. In addition, 100% foreign ownership is permitted in ITES and software industry. Kishore Mirchandani, Chairman and CEO, Business Process Outsourcing (India) Private Limited surmises, "From the perspective of a BPO service provider, India is a country

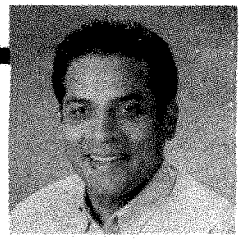
P17280

of choice for outsourcing a variety of functions. India is not only technologically advanced, but also ensures quality, controlled costs and is defiantly competitive."

The other side of the coin

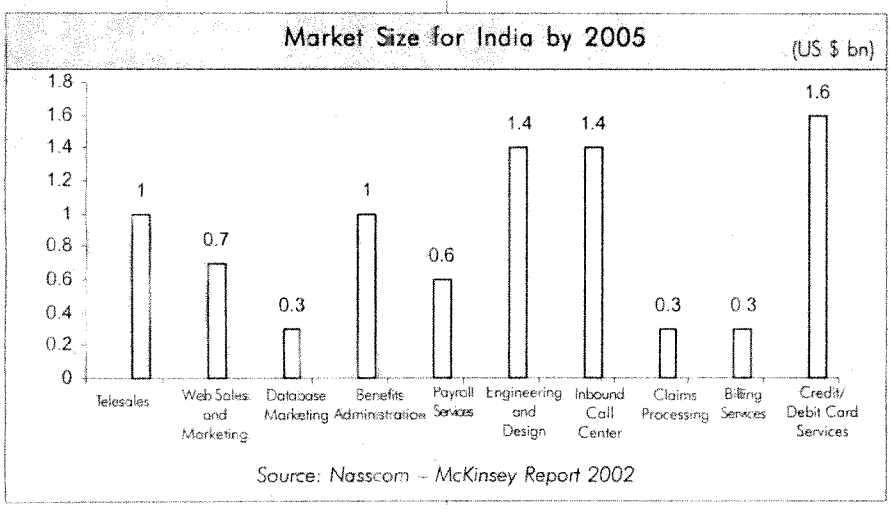
However, not all is rosy. Many large companies are wary of the security concerns with regard to their data. In fact, it is one of the most important considerations that determines the destination of BPO. At the operations level many companies are undertaking necessary security measures to assure clients of the safety of customer data. For example, Progeon, a BPO provider, which is fully owned by Infosys, takes a very tough stand when it comes to the security of client's data. GreenPoint Mortgage entered into a $30 mn, five-year deal to outsource some of its back office and customer's service to Progeon. In order to ensure security of the data, Progeon took the following measures. Firstly, it established a separate facility for the GreenPoint account restricting the physical access to the building to authorized employees only. Then Progeon created a secure computer network, which is not connected with the rest of the company. The third initiative was to ensure that the network connection to GreenPoint's US offices runs through two fiber optic cables instead of one. In addition to these measures Progeon demands that its workers sign non-disclosure agreements and submit to background checks. While at operational level the initiative of the BPO provider might mitigate security concerns, the larger concerns about the country as a whole remain. The tension between India and Pakistan and the talk of terrorism acts as a great dampener in international arena. After the September 11 attacks the issue of terrorists raises concerns in many a prospective customer.

The second major concern is the infrastructure. The condition of power, telecom etc., is not very reliable in India. In fact, most of the facilities must maintain alternative sources such as generators to stand-by in case of a power failure. In the case of telecom too India cannot boast of good facilities or speedier dispersal of applications. Philippines offers a better situation in terms of the cost and the availability of the fiber optic service, which had attracted eTelecare International, a BPO provider based in Los Angeles to set up a facility offshore. In addition, the telecom costs too are much lower in the Philippines. Krishan Dhawan, Chief Marketing Officer, Exlservice Inc., avers, "...there are several roadblocks in the BPO growth trajectory. These range from nascent licensing policies, labor law restrictions, interconnectivity and technological restrictions, power supply problems, bureaucratic delays, inadequate regulatory support, ambiguous laws on e-business, data protection and privacy, unclear definition of ITES/BPO and lack of training infrastructure." If India really wants to buck the trend of BPO it will have to move up fast and address these issues. A number of half-hearted measures do not serve the purpose; the need of the hour is an initiative on the part of policymakers to create a conducive environment.



"There are challenges and opportunities for any start-up in an emerging industry. Established software companies have the advantage of an existing brand. But, start-ups can capitalize through deep domain expertise, strategic partnership and leveraging clients."

Atul Vashistha
CEO, neoIT



Source: Nasscom – McKinsey Report 2002

BPO – The big-ticket game

BPO in India is in a nascent stage and like any other budding segment is overcrowded. And as a result there is overcapacity.

Broadly, there are three major kinds of players. The first segment consists of what are popularly called captive centers or shared service centers. These are offshore operations specifically established for back office operations owned by the company itself. Examples are GE, American Express, Citibank,

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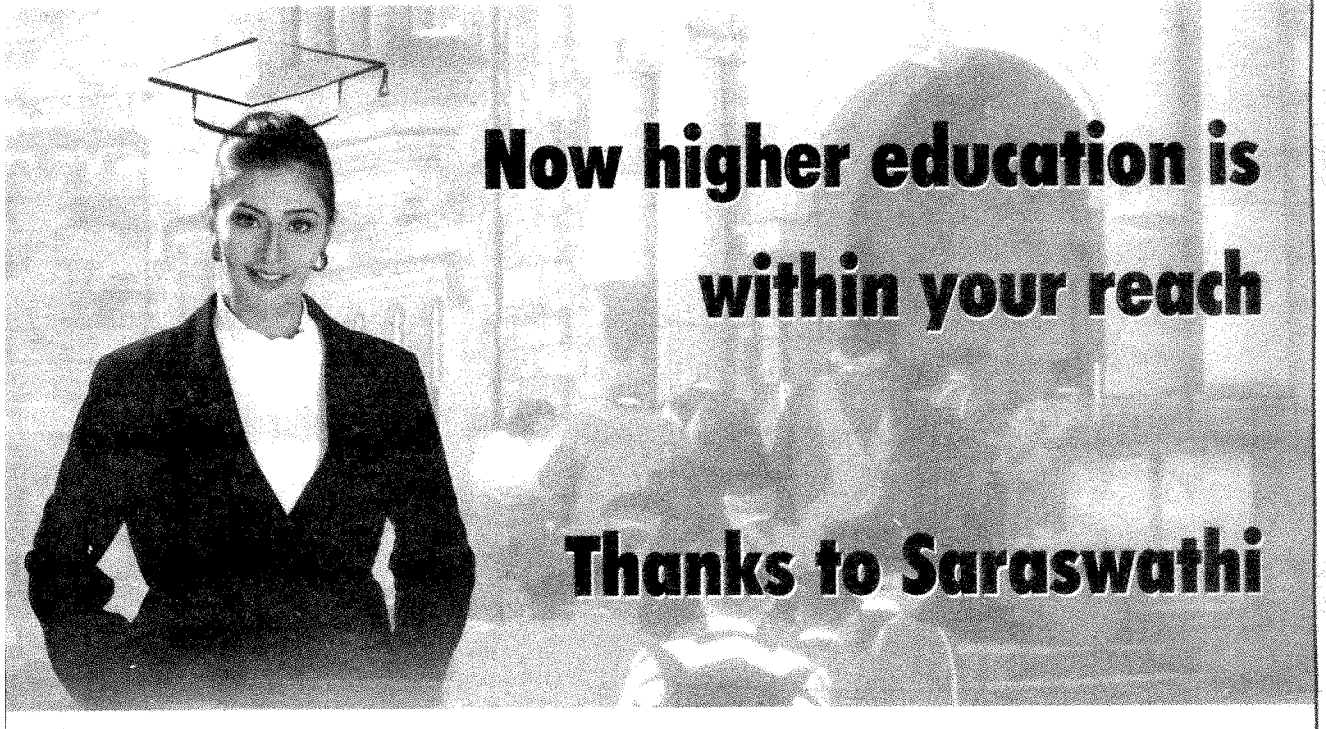

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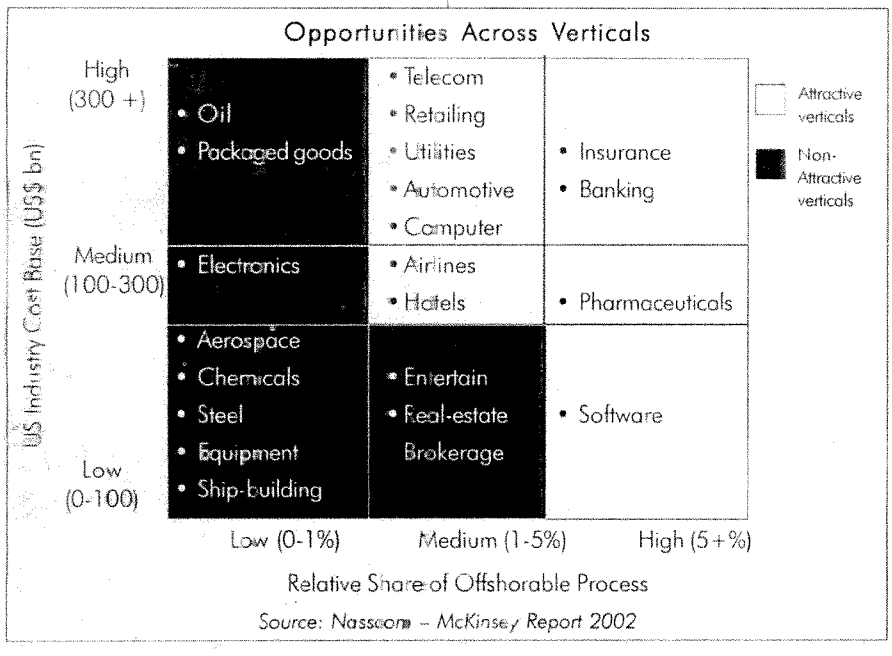
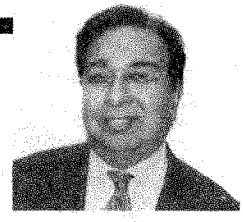
British Airways, Dell, etc. that have set up large operations in India to do back-office processing and customer support for their global businesses. The second important category is the third-party BPO service providers such as Exl Services.com (I) Pvt. Ltd., Daksh eServices Pvt., GTL Ltd., Datamatics Technologies Ltd., Tracmail India Pvt. Ltd., Brigade Corporation, Epicenter Technologies Pvt. Ltd., Firstring, 24/7 Customer etc. The third and more recent trend in the BPO sector is that of frontline software companies entering the BPO arena through acquisitions or by establishing fully owned subsidiaries such as Infosys-Progeon, Wipro-Spectramind etc. These software companies would be leveraging the brand name as well as their contacts for the BPO business. For clients this would mean a company, which offers an end-to-end solution from customer service to back office services to system integration to software development. In addition to these major segments there are others including consulting companies like Accenture entering the BPO arena, big industrial houses such as the ICICI making a foray.

So, who has the advantage among these three major segments and how would the future of the industry landscape look like. To begin with companies that have captive operations are definitely reaping huge cost advantages and expanding their facilities too. The prospect of setting up outsourcing operations in India is definitely good for them and for India too since it means thousands of jobs. Rohit Chand, Executive Chairman, IT&T Ltd., claims, "Whether the BPO activity is predominantly captive or not does not impact India, as long as the business outsourced to companies operating out of India. Consider GE, it employs more people in India than in US. Establishing its operations in the mid-1990s, GE facilities in India have not only delivered but have scaled up the value chain. From a situation where most of the jobs handled were routine such as collecting money from delinquent credit card users, GE's Indian operations, have moved up to handling complex task such as data mining. Even in the case of captive operations companies would prefer to be doubly sure that complex tasks could be handled well and with adequate quality parameters. Once that confidence builds up the scope is endless.



Source: Nasscom – McKinsey Report 2002



"However most of these players do not have any expertise in the field and the future will witness a few strong players dominating the market."

Kishore Mirchandani
Chairman and CEO
Business Process Outsourcing (India) Private Limited

The second segment of the BPO market is the third party BPO service providers. This is the category that is particularly overcrowded with a number of small players who have jumped in on the bandwagon to make a quick buck. But this might be easier said than done. The major issues here are that establishing a successful BPO needs economic might and adequate funds. Subhendu Mitra, Chief Operating Officer, Ibackoffice.com points out, "Setting up a BPO business is cost intensive due to high telecom costs. Start-ups should ensure they are not undercapitalized to meet minimum capacity requirements. This business to a large extent is a volumes game and companies with higher capacities achieve profitability at lower cost per seat. Availability of capital till revenues start coming in will be the key issue. Second, most important aspect is to ensure there is a strong sales and marketing plan in place to generate the first few clients." Further the problems are complicated because cycle times in BPO sector are anywhere between 6 to 12 months. This could severely strain the financial situation of the

irm. In addition, one common omment that is doing rounds is hat while Indian firms are good at uilding facilities or even in lelivering the service, they are not aying sufficient attention to narketing their brand name in the arget countries. Rohit Chand varns, "Start-up companies will ave a difficult time in marketing hemselves and will essentially ave to initially operate on wafer-hin margins to win business."

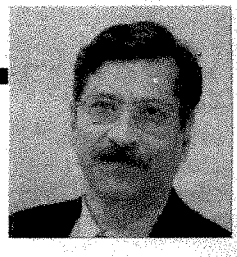
It is these companies that night be prey to the shakeout in he industry. Arjun Vaznaik, mphasizes, "Shakeout will involve hird parties being bought out. Aore captives and joint ventures vill be set up." Atul Vashistha, EO, neoIT says, "...The larger ompanies will continue to acquire he knowledge and processes of the maller firms in order to complete heir BPO offerings. Firms will artner, build and acquire new apabilities. ...Some companies vill look to partner with BPO firms utside of India, including the US, hina, Philippines, Canada to rovide global coverage. This is not space for small players."

"Currently, IT services is more than 10% of India's GDP. If India is to grow the BPO opportunity substantially in the next four years to say 10 billion from two billion then this contribution could be as high as 15-20% which is substantial."

Arjun Vaznaik
Chief Operating Officer
Tracmail

Enter software biggies

The third segment is that of frontline software majors such as Wipro, Infosys entering the BPO space. They have the contacts, the financial clout, and the brand name in their favor. But this is an entirely new business arena for software companies. Krishan Dhawan observes, "Indian software companies have started making an attempt to enter the BPO space given the current downturn in their industry. They feel they can leverage their client contacts to make a start in the BPO space. BPO is viewed as an extension of services being provided. It will never be the focus of the software companies' operations." Further, he feels that software developments and outsourcing business processes are two entirely different arenas. Thus, expertise in one might not necessarily translate into expertise in the other too. Furthermore the focus is different in a typical software development environment; the responsibility ends once the project is implemented and is in place but a typical BPO operation requires an ongoing relationship with the client over a long period of time. In fact to provide seamless service, the BPO provider should put himself in the shoes of his client and ensure customer satisfaction. To add to that the operational issues such as hiring, training and managing large number of agents, transitioning and migrating processes from client site to the remote site and running them on an ongoing basis is a game where the software majors have not tried their hand yet. However, software majors such as Wipro are entering the business through acquisition of an established player, which might neutralize the lack of operational experience on the part of Wipro. Vaznaik foresees, "Software companies have an existing client base to tap and lock into especially if they maintain and support the back-end systems of their clients. The issue is not of start-ups against



"India has to remain cost-competitive. Over time, Indian technical manpower tends to overprice itself in the global market unlike the Philippine and Chinese manpower and these are our major emerging competitors."

Rohit Chand
Executive Chairman, IT&T Ltd.

software companies but MNCs against software companies."

After the initial shakeout the industry might be largely dominated by captive centers and the joint ventures of Wipro-Spectramind type. Captive centers will cater to the large MNCs while the other BPO providers will focus on the companies that do not have the resources for setting up their own offshore facilities. Kishore Mirchandani agrees, "Large MNCs have the ability to manage their own Shared Service Centers offshore. The opportunities for BPO players are working with companies that do not have the resources for setting up their own offshore facilities. The growth thrust will therefore primarily be in this area."

The future

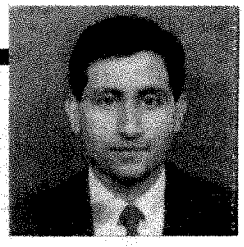
The pitch is good, the market is upbeat, and business is pouring into the BPO sector in India. However, there are voices of discontent that are being heard in the US. For instance, a bill has been tabled in New Jersey Senate, if passed might restrict the public companies from being outsourced to India. The discontent is largely due to the transfer of jobs from US

that too in a recessionary environment. Will this have a major impact? None of the people interviewed thought so. They were unanimous on this one point that it might have a insignificant impact. The reasons: Firstly it would only be public companies, which might be coming under this legislation. With the likes of GE, HSBC, Citigroup being out of the purview, it might not take away business. The second reason is historical evidence; given the firm belief of US in free market economy it might not take an in principle stand supporting such an Act. But the third and most compelling dimension is that of economic compulsions. Subhendu Mitra concurs, "Under the current globalization scenario it will be difficult to ignore economic considerations. Every business the world over is looking into reducing its cost. If outsourcing is going to bring in significant cost reduction there is no way the company can ignore. Eventually everyone will agree to this and accept the fact that outsourcing has come to stay."

No doubt outsourcing is here to stay but the moot question is how should India retain the business within its boundaries? Krishan Dhawan believes, "Cost savings and labor arbitrage would cease to be differentiators in the long-term as other countries try to catch up. In the long-term, process improvements and re-engineering, bringing about real savings either through productivity enhancements or reduction in turnaround time or costs, would allow service providers to move up the value chain and handle more and more complex processes, higher up in the value chain." The BPO industry has some lessons to be learnt from the IT industry. The Indian software sector too made a foray into the world markets riding high on the cost differential and once it made inroads, it has locked in the customer using its quality consciousness, ability to deliver better products and scale up to the higher end of the value chain. But software industry has learnt this through experience. With the precedent set, the BPO sector may avoid getting into the loop and realize the importance of not only scaling up but also moving up fast to the higher end of the value chain.

Prakash Gurbaxani maintains, "...for service providers to succeed it is imperative that they have a strong focus on People, Processes, Technology and Infrastructure with a strong management team to knit these critical elements together. Service providers need to be able to utilize their infrastructure effectively to be an efficient player." He further points out, "Consequently, it is important to be able to blend real-time/ call-center and non-real-time/ back-office processes as companies (specially the large *Fortune* 500 companies) are looking for service providers who will serve as one-stop-shops for their requirements. Further, it is important to have multiple sites and the ability to scale-up quickly to meet clients' business requirements as well as provide for contingency planning." Post September 11, many companies have become very touchy about the security issues and in such a scenario gaining the confidence of the client would be all the more important for companies.

In the long run, attracting and retaining highly motivated workforce could prove to be a problem. Arun Natarajan opines, "The way in which the industry handles the HR issues will be a key factor. (For example, the long-term impact of working night shifts is not yet known.) Another factor is how companies manage the career growth prospects of their customer support executive workforce." BPO industry in India is spreading across various sectors involving both low-end and high-end activity. The major activities include call centers, medical transcriptions, claims processing etc. Scientific research, data mining, providing technical support are some of the phases that



"Although the trend is to set up in-house BPO operations, there will always be second tier companies who will find outsourcing a better proposition than having in-house."

Subhendu Mitra
Chief Operating Officer
Ibackoffice.com

are catching up with the market. With this kind of a breadth and depth of offerings, India would surely attract companies looking for outsourcing opportunities. Atul Vashistha foresees, "The BPO companies that have been around for a whole are also looking to expand their offerings into other areas by building their core competencies internally or by acquiring smaller players." But to retain this advantage, Indian firms should take care of the major concerns including maintaining quality, ensuring higher motivation of the workforce, ensuring security of data (by investing in back-up and de-risking their businesses sufficiently) and moving up the value chain. BPO is definitely a sunrise sector in India with bright prospects in the long-term. But the challenge is to retain the competitive advantage as the preferred destination.

Related Articles:

1. Business Process Outsourcing in India: Gaining momentum, *Analyst*, August 2002.
2. Outsourcing: A success formula, *Analyst*, October 2001.

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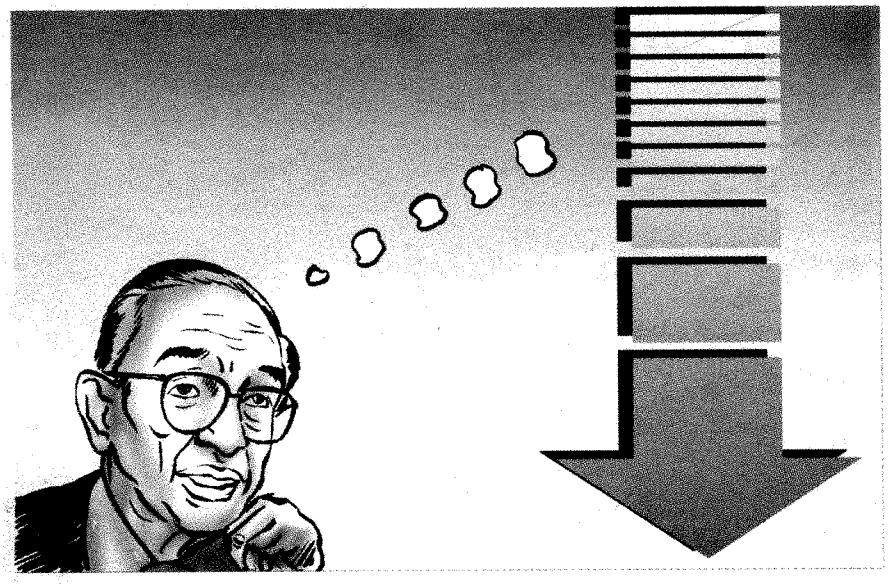
US INTEREST RATE CUTS

The last resort?

A series of rate cuts in recent times has hardly helped to revive the US economy. Yet, the Fed appears to be relying on it to kick-start the economy. Will the Fed Chief finally be successful?



A series of corporate scandals, and the possibility of war with Iraq has made businesses reluctant to invest in equipment and create new jobs. Consumers, whose spending accounts for two-thirds of all economic activity in the US, have turned more cautious due to turbulent stock markets, and sinking confidence in the economy. Amid such concerns Federal Reserve Bank of US attempts to boost the economy by bringing down the interest rate. By doing so, Fed policymakers hope to motivate consumers to spend more and businesses to ramp up investment, something that would boost economic growth.

The Fed has cut the short-term interest rates by a half-percentage point to 1.25%, its lowest level in more than four decades. Since December 11, 2001, the Fed started an extraordinary series of 12 rate cuts in 11 months that brought short-term rates to their lowest levels since the early 1960s. Increasingly worried that the economic growth is close to stalling, the Fed Chairman Alan Greenspan and company acknowledge that the present rate will help the economy to run into a 'soft spot' after a surge in activity earlier this year.

However, the present low rates are a sign of how seriously Greenspan and company regard the failure of the US economy to sustain a stronger recovery this year. They do not expect the economy to slip back into recession, but they are using the only tool at their disposal, interest rate cuts, in an effort to make sure that does not happen. Analysts think the Fed is signaling that the worst is over and the rate cut is an insurance policy to spur growth. Now the Central Bank is of the view that a renewed slump would cause unemployment to increase, business profits to fall and perhaps stock prices to slide further. They also want to make sure that economic weakness does not cause the overall level of prices of goods and services to decline, a condition known as deflation.

Low interest rates – The other side of the coin

Rate cuts are generally good news for the economy because they encourage banks to lower their interest rates (many banks were expected to announce a similar half point reduction, lowering the prime lending rate to 4.25% which would be its lowest rate since May 1959), making it easier for people to borrow money. However, retirees and other people who live on interest income will whimper. Experts say Americans are struggling to dig out from debt; surprisingly a big cut in interest rates by the Federal Reserve may help very little. Low interest rates encourage consumers to borrow even more, exacerbating the country's financial imbalances and simply postponing the day of reckoning. On the other hand, a feeble economy with the inflation already low could lead to deflation. If deflation were to take hold, it would be harder for consumers and businesses to repay their debts, which in turn could further depress the economy. Deflation could also reduce the ability of monetary policy to revive the economy, as it has in Japan, which hit the zero-interest rate problem years ago. Is there a scope that as rates approach zero, conventional tools like monetary and fiscal policies become less effective. "It's not", says Stephen G Cecchetti, Department of Economics, The Ohio State University. There would be a need for a change in policy regime, but

"With interest rates and inflation closer to zero, it would be more difficult for monetary policy to have an impact, and they may have made a bigger-than-expected cut for that reason"

– **Mark Gongloff**, Staff Writer, *CNN/Money*, New York, Mark.Gongloff@turner.com

■ ***On the US economy's double-dip recession, a series of rate cuts by Fed in recent times***

It depends on how one defines a recession. The NBER, the respected think tank that sets the dates of recessions and expansions, considers job growth to be its most important economic indicator, and we have clearly seen job growth in the US recover for a few months and then plunge again.

Meanwhile, the manufacturing sector—another component tracked by the NBER—also recovered briefly before falling back into contraction again.

Given these two indicators, it would not surprise me at all to find that the overall economy shrank in the fourth quarter, or was at least very close to it. Most economists think this is simply the 'soft spot' described by Alan Greenspan and that the economy will pull back out of it. There is an outside chance, however, that the weak job growth could continue for several more months, putting pressure on consumers, who could be inclined to curtail their spending anyway, considering their high levels of debt. Many economists believe some other form of stimulus—in the form of tax cuts or government spending—will be necessary to get the economy going.

■ ***On interest rates and revival of the US economy***

Not only are interest rates as low as they have been in 40 years, but consumer debt levels are high and getting higher. With all this in mind, it seems logical to believe that consumers will eventually lose their appetite for more debt and other forms of stimulus will be necessary.

This is not to say that a rate cut is absolutely useless—any cut will have some impact. But, based on the lesson of Japan in the 1990s, there may have been some concern at the Fed that, with interest rates and inflation closer to zero, it would be more difficult for monetary policy to have an impact, and they may have made a bigger-than-expected cut for that reason.

■ ***On efficacy of monetary and fiscal policies***

First of all, I do not know if it is necessarily true that all fiscal policies become less effective with interest rates close to zero. I suppose it depends on the particular policy measure and the economic situation when that measure is passed. But monetary policy may struggle to move the economy when interest rates are close to zero, especially if inflation is also close to

monetary policy clearly remains effective. Remember, the Central Bank's control over the size of its balance sheet does not go away just because interest rates fall to zero. Good policy is always a close call, and so in most circumstances 'neutral' is the right posture. That's the case here. Concuring the same view, David Wyss, Chief Economist, Standard & Poor's, US, opines that, "There is little evidence that policies become less effective as interest rates approach zero." He further says that, "The problem is that rates can't go below zero. Fiscal policy shows every sign of functioning, but there are limits to the effective size of deficits. Policies can avoid deflation, but once deflation takes hold, it is very hard to get out of it." When interest rates reach the zero lower bound, the Central Bank loses its main policy instrument. However, monetary policy does not become fully ineffective, since it may also effect economic activity by expanding the monetary base or by manipulating the exchange rate. But these channels of monetary policy transmission are not well understood, so that a situation where interest rates are zero must be a horror scenario for every Central Bank. The effectiveness of fiscal policy does not depend on the level of interest rates.

"I expect the Fed to cut rates again in January, unless the December sales data are stronger than expected.

David Wyss
Chief Economist, Standard & Poor's
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The deflation dread

Most economists say the US faces little real threat of deflation. "Inflation has always seemed a more likely scenario than deflation, but deflation is far more serious," says Wyss. The real risk is that inflation will increase, but the threat is certainly not imminent.

zero. One trick policymakers like to use to jump-start a sluggish economy is to move interest rates below the rate of inflation, making it more costly for people to hold on to money than to spend it. If inflation is zero or negative, it obviously becomes much more difficult for policymakers to do this.

In the United States' case, policy might also be less effective at this point because consumers have already taken advantage of super-low interest rates and have amassed large levels of debt. Another rate cut here or there might not necessarily give them much incentive to borrow still more money.

Furthermore, the Fed likes to make dramatic cuts to impact psychology, when it feels such a move is necessary. Shortly after September 11, 2001, for example, the Fed slashed 50 basis points from short-term rates just before the New York stock markets reopened. Obviously, if its key interest rate is at or near zero, the Fed will have little or no ammunition to make such moves.

■ ***On the rate cuts***

Barring some major exogenous shocks—another major terrorist attack or a war in Iraq that goes badly or takes longer than expected—or an unexpected downturn in economic activity, the Fed is inclined to pass the job of getting the economy moving again to Congress. It indicated as much by slashing rates more than expected while simultaneously shifting to a 'neutral' bias. This was the Fed's way of saying, "Here's your rate cut. Now leave us alone."

■ ***On the risk of inflationary pressures***

Some economists with whom I spoke on the day of the cut laughed out loud at the idea that the Fed honestly thought the risks to the economy were balanced between weakness and inflation—clearly, the risks were tilted more towards weakness. But, as I said above, this was the Fed's way of saying—without actually just coming out and saying it—that it had no intention of cutting again any time soon.

■ ***On the similarities between Japan and the US***

I should note that Japan's situation is different in several ways from the current US situation. Most economists say there are severe problems with the Japanese banking industry which is one key point of difference between the two countries. In fact, the US banking industry which is in much better shape and in a better position to extend credit than their Japanese counterparts.

On the other hand, there are several points of similarity between the US and Japan. Both countries experienced an asset-price bubble that popped, leading to an economic downturn. The central banks of both countries responded by slashing interest rates. Japan's economy responded well to the interest-rate cuts at first, but a series of exogenous shocks in the mid-1990s were more than the fragile economy could bear, and it fell back into recession. Many economists are concerned that exogenous shocks could have a similar impact on the US economy. It is recovering now, but hesitantly another major terrorist attack or some other shock could set the recovery back.

The core inflation rate (CPI excluding food and energy) has been stable in the 2 to 2.5% range for three years. The swings in the overall rate have been due almost entirely to energy prices.

There are clearly signs that price growth has slowed to a crawl. This leads to a vicious circle. Prices fall when consumers have no desire to buy and they postpone spending because they believe prices will fall further. Then businesses can't make a profit or pay off their debts, leading them to cut production costs and staff. This in turn leads to a lower demand for goods, which leads to even lower prices. The nightmare scenario for the Fed is a situation in which it cuts rates to the bone, but the economy can't get going—a situation Japan has found itself in during its prolonged recession. However, Dr Boris Hofmann, Senior Fellow, University of Bonn, opines, "the Bank of Japan's rate cuts did not help to revive the Japanese economy because of a rotten banking sector. The US banking sector appears to be sound, so that the Japanese story will not be repeated in the US. After its decisive rate cuts the Fed does not have much ammunition left to fend off another negative exogenous shock. The US Fed may face the zero bound if such a negative shock occurs." However, given the current situation, the most likely scenario is that rates remain unchanged in the first half of next year, followed by a modest monetary tightening in the second half. US policy rates are at a historical low at the moment. Given the transmission lag of policy measures, the Fed's rate cuts are not yet fully reflected in economic activity. Hofmann adds, "I do not expect to see further rate cuts unless the US economy is hit by a further negative exogenous shock, such as another terrorist attack."

However, many experts pooh-pooh efforts to compare, the US to Japan, saying the deflationary death spiral that crippled Japan could never do the same thing to the world's biggest economy. Not only is the US banking system in a far healthier shape, but also the Fed's plans entail bypassing the banking system and dumping money directly on the public. Though it's true that there are important fundamental differences

between the two nations, there are plenty of alarming similarities. Both had large asset-price bubbles and central banks in both nations raised interest rates and popped those bubbles; both had companies and households saddled with debt.

Wyss is of the view that the Japanese-style extended deflation is the Fed's worst nightmare, but we don't seem likely to go that way on our own. Excess saving in a financial system that has become bankrupt creates that scenario. Neither is likely in the US. The threat really is being sucked into a world deflationary spiral. The absence of expansionary policies in Europe is increasing that possibility. He further adds, once in deflation, policies hit the limit of effectiveness. The Fed has shown more willingness to take bold steps earlier than the Bank of Japan, and political constraints on changing bank policy and industrial rules are smaller in the US than Japan.

The Fed itself indicated that it's aware of the similarities; in June 2002, it published a study about deflation in Japan and how monetary policy could have prevented it. The study says deflation can be avoided with more aggressive monetary policy action when inflation and interest rates are near zero. Japan's deflation could have been dodged, for example, if the Bank of Japan had only cut interest rates by two more percentage points between 1991 and 1995. Japan's failure showed the risks of timidity and political deadlock rather than the weaknesses of an aggressive money-printing campaign, the study says.

Testing times for the Fed?

The Fed's move came as the National Bureau of Economic Research (NBER), a leading body of economic researchers, declared that it could not be certain that the US economy was yet out of the recession. Some of the Fed's critics think that interest rates should have come down earlier. Indeed, two members of the Federal Open Market Committee (FOMC), the policymaking body that decides on interest-rate changes, wanted a cut at the last meeting in late September. They were convinced at that stage that monetary policy needed to be eased. The sharp rise in long-term interest rates (not directly controlled by the Fed, but they tend to follow short rates after some lag) in recent weeks suggests that the markets, like the Fed, regard deflation as a possible but highly unlikely eventuality. The FOMC's decision to cut rates for the first time since December 2001 comes amid mixed economic reports that have tended towards the downside. These include high unemployment, contracting manufacturing, declining consumer confidence and rising concern among investors and the public over possible US military action against Iraq.

The NBER says that although "the behavior of the US economy in the first eight months of the year indicates the decline in activity that began last year may have come to an end. Recent data indicates that additional time is needed to be confident about movements of the economy." In December, new data on weak consumer confidence and spending has given the Fed additional reasons to cut rates. Big-spending consumers, who splurged on items like new cars using cheap or free credit, have held the US economy above water. But now that spending is slowing down, rising unemployment may make consumers reluctant to take on more debt.

In general, interest-rate changes typically take at least six months to have any effect on demand and their full effect feeds through only after a year or more. Analysts say while interest-rate cuts can certainly soften a recession, they may be too late to prevent one entirely. Also, given that American households already have alarming levels of debt and negative rates of saving, cuts in interest rates may be less effective than usual in spurring new borrowing and spending. Many forecasters say economic growth in

"There is absolutely no chance that the US is on the same road as Japan. Our banking system is healthy and our policymakers know what they are doing. And remember, interest rate cuts are not the only bullets in the policymakers' guns."

Stephen G Cecchetti
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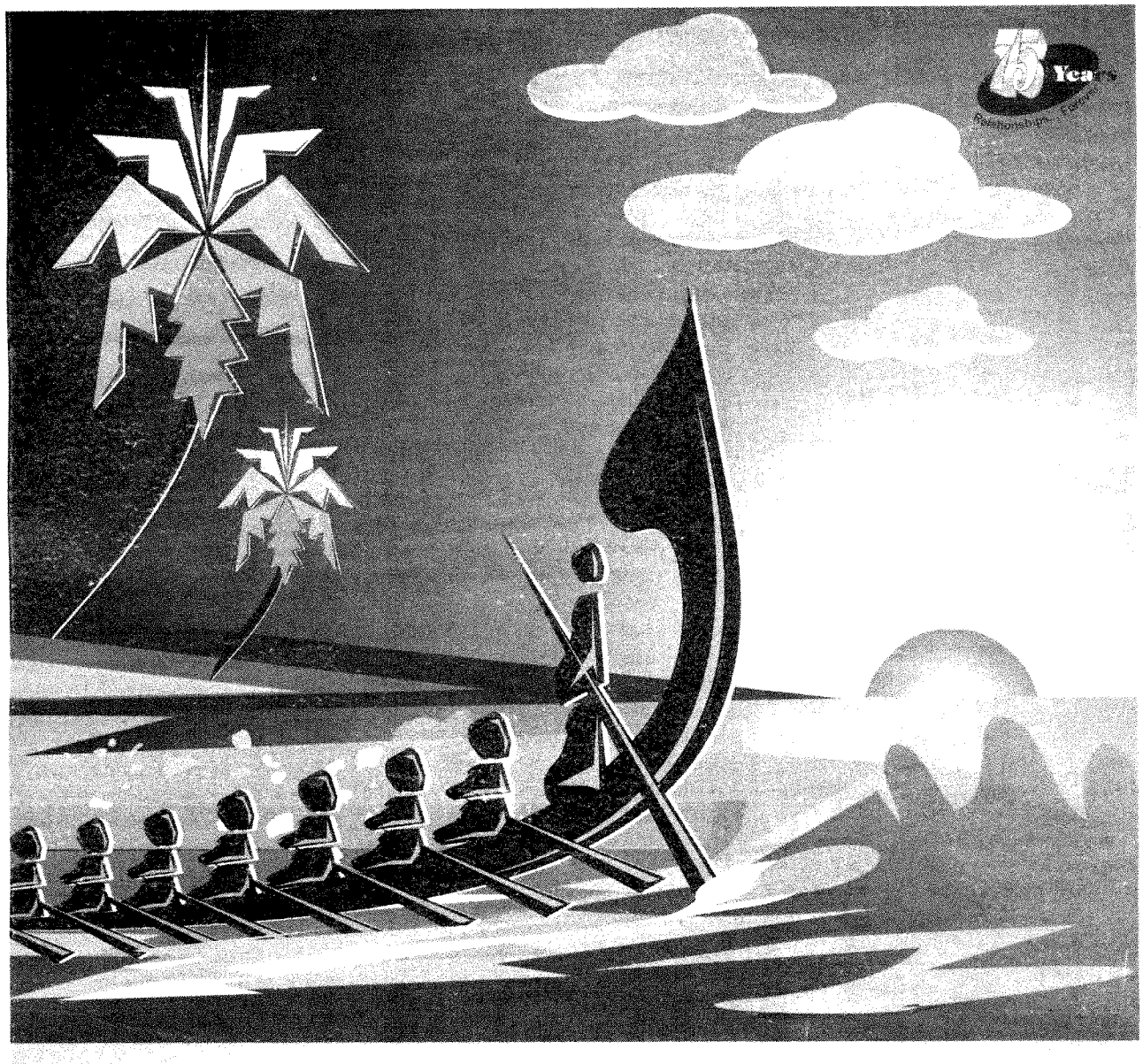
Interest Rates in India

Interest rates in India too have been crashing for over a year. A combination of surplus liquidity, low inflation and the general decline in global interest rates has resulted in interest rates in India touching new lows. The yield on benchmark 10-year paper had recently crashed to a record low of 6.31% very close to the bank rate of 6.25%. The trigger was provided by October-end credit policy, which has reduced the bank rate from 6.5 to 6.25% and CRR from 5 to 4.75%. Banks have reduced their deposit and lending rates. The maximum interest rate on bank's deposits, which used to be as high as 13-14% four/five years ago have been consistently reduced to 6-6.5%. Similarly, the lending rates of banks (PLR) reduced from as high as 18-19% to 11-12% as of now.



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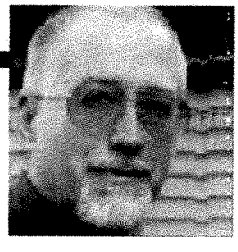
the current October-December quarter could slow to just a 1% pace, down from a 3.1% growth rate in the third quarter. At this juncture, these are testing times for Alan Greenspan and company. However, Wyss opines, "The US economy is growing, and unless there is an outside shock (oil markets, terrorism), I expect growth to continue. The pace is slow, but growth has been 3.2% over the last four quarters, respectable by historical standards."

Interest rates – How low can they go?

Is the Fed right in continuing lowering rates, and how much further can they go before inflationary pressures begin to build? Is it the final dose of shock therapy? The stock markets and exchange rates as well as the 'real' economy are fundamentally affected by the level of interest rates, although each is affected differently and interact to some extent as well. Analysts say as the Dow declined by 1600 points over the past month, there is evidence that panic is growing among both individual and institutional investors. The dollar is also weakening against the euro. Under these circumstances, the Fed cannot raise interest rates without strong objections from Wall Street but this also cuts off the way Alan Greenspan could stem the fall of the dollar. He faces a crunching dilemma and the only thing in his favor is that inflation is low so there is no pressure to raise interest rates from this direction. The key to resolving this dilemma rests on a strong economic recovery in the coming year.



"I'd say that the recent interest rate cut is not enough. It also requires much work on the fiscal side of the equation. With its new economic team, I believe the Bush administration intends to head in that direction."

E G Ross
Editor, The Objective American, *US*
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However, an indication of how low interest rates could go is the zero interest rate incentives on some car and truck sales started by GM and Ford a year ago. Consumers have responded favorably, but market shares for both auto firms continue to decline. This suggests that interest rates alone will not be enough to boost economic recovery. The Fed now believes that risks to the economy in coming months are equally balanced between inflation and slower growth.

Outlook

With businesses shy of new investment, the adage, "You can bring a horse to water, but you can't make it drink," aptly describes the business investment climate right now. It has been left to consumers to keep the US economy afloat. However, they have done their bit, keeping their wallets open despite the steep fall in share prices. The cushion has come from the booming housing market.

Greenspan says the economy faces neither inflation nor deflation and companies are more productive. Rising home prices, tax cuts and extended unemployment benefits have helped keep consumer spending from falling off as much as some economists predicted. Punishing corporate wrongdoers and resolving tensions with Iraq may help remove doubts.

"Given the current situation, the most likely scenario is that rates remain unchanged in the first half of next year, followed by a modest monetary tightening in the second half."

Dr. Boris Hofmann
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However, analysts have suggested that President Bush was keen to rid his team of perceived weaknesses in the run up to the 2004 presidential elections. Opines E G Ross, Editor, *The Objective American*, US, "I expect the package will include payroll, income, and capital gains tax cuts; tariff reductions; caps on punitive damage awards; and a program to reduce bureaucratic red tape, which has built up over the years like barnacles on a ship's hull. I would support all these moves. They are classical, pro-capitalist policies that will liberate human creativity and spur innovation and entrepreneurship." Whatsoever, the Fed's directive, the greater risk is economic weakness, raising the need for rate cuts. Later the fact that the Fed might have to lower rates again would be worrying in itself.

Related Articles:

1. US Interest Rates: Reflecting the economic pulse? *Analyst,* May 2002.
2. Interest Rates: Why they should go up in India, *Analyst,* January 2002.

N Janardhan Rao

Reference # 1-2003-01-04

BANK MERGERS

Is it the right solution?

Are bailout mergers a viable alternative for beleaguered banks?

The banking sector in India is undergoing a phase of transition owing to increased competition and changes in regulatory scenario. This is forcing the banks to shed flab and become more technology oriented. Many banking companies are adopting steps like enhancing retail loan portfolio, reducing NPAs and adopting latest technologies to improve their performance.

The rapid changes in the business environment require diligent measures from banks if they have to survive in the long run. Smaller banks particularly the private sector banks are finding it difficult to cope with the competition. With time it looks like the relatively smaller banks will have to either closedown their operations or look for a sound merger partner. The decision of closing down a bank has to be made after taking into consideration the social and economic aspects tied to it. Restructuring is another alternative. But it may end up burdening the country's exchequer and the success of the bank again depends on many other factors like the management of the bank.

The last alternative is the option of merging a weak bank with that of a sound one. Mergers in the banking sector have been a known phenomenon, wherein banks merged in pursuit of synergy benefits and to penetrate into new geographical segments. But what happens when a sick bank looks for a merger partner? Unless there are any apparent benefits, it ceases to be a potential merger candidate. It has no other option than to either look for RBI's help or close down its operations.

Value enhancing or forced mergers?

Recently two public sector banks—The Punjab National Bank and Andhra Bank made news for their proposed mergers with two weak banks—Nedungadi Bank and Centurion Bank respectively. Contrary to the popular belief that these financially sound banks were directed by RBI to consider the merger of the above said weak banks, Professor D Ghosh Roy, Director, B D P Consultants, Pune, says that "RBI's role is primarily advisory as regards any merger. World over financially sound banks only have been taking over weak banks. You don't expect a financially weak bank to takeover any other bank. No society (or for that matter any government) can afford a bank to close down, without a sincere attempt in reviving it. Among the several alternatives available for reviving a bank, merger is one. The takeover of Times Bank by HDFC is one such case, where a strong bank took over a weak bank. In the public sector, the lessons from merging New Bank of India with Punjab National Bank, has given sufficient inputs to the RBI as also to the government in not forcing (or directing) any strong bank to take over a weak bank."

Essentially merging a sick bank with a healthy one is a bailout strategy for the sick bank. These kinds of mergers may end up eroding the shareholder value of the financially sound banks. But according to Prof. Roy, "whenever a merger (including the proposed merger of Punjab National Bank with Nedungadi Bank Ltd) takes place there are transparent methodologies available to calculate the ratio of shares of the merged bank *vis-a-vis* the bank which has taken over. The aggrieved shareholders have all the right to appeal to SEBI along with recourse to legal action, including bringing a stay on the merger."

Nedungadi Bank: Is it a bitter pill?

The case of the proposed merger between the Kerala-based Nedungadi Bank and the public sector giant Punjab National Bank

(PNB) is an interesting example of a merger between a financially sound bank and a sick bank. Even though Nedungadi Bank is small fry for PNB, considering the fact that the total advances of Nedungadi Bank amount to only 2.24% of the total advances of PNB and the deposits a meager 2.24% of PNB's total deposits, the merger can create major hurdles in the growth of PNB (See box: Merger of Unequals).

If PNB, in future decides to raise additional capital to deal with the problems caused by the non-performing assets, the cost of capital will obviously increase and this may affect its performance value in the long run. PNB is in the big league in the West and Northern parts of India with little presence in South India. In contrast, out of 173 branches of Nedungadi Bank, two-thirds are located in Kerala where PNB has 20 branches. The acquisition will definitely strengthen the presence of PNB in Kerala, but the question is whether the bank is interested in a state whose economy is in doldrums.

Albeit the cost of getting an entire new branch network is less than Rs. 35 cr, PNB has to take care of the NPAs and additional investments in developing the acquired branches in terms of computerizing them. Even for a bank as large as PNB it may in the end prove to be a costly exercise. However, a fresh evaluation of the bank may be needed in case the merger materializes. Punjab National Bank only recently completed its IPO and trading has been on for less than a year.

Centurion Bank: Second time lucky

The proposed merger will be second in a row for Centurion after the RBI allowed it to merge with 20th Century Finance a few years ago. The merger didn't help the embattled bank, which has failed to respond to the challenges posed by the changing scenario in the banking sector.

Centurion Bank posted a net loss of Rs. 161.8 cr for the year ended March 31, 2002. It also incurred a net loss of Rs. 3.6 cr for the first quarter ended June 30, 2002, even though it has made an operating profit of Rs. 7.8 cr. On March 31, 2002, it had negative reserves of Rs. 97 cr and an equity capital of Rs. 152 cr. The capital adequacy ratio as on that date stood at 4.16%, which further declined to 4.05% on June 30, 2002. The bank has however cleaned up its balance sheet with a provisioning of Rs. 176 cr for the past year. It has made a provision of another Rs. 11.4 cr during the first quarter of the current year. The bank has also bolstered functioning of its branches and improved the marketing network. Similar to the PNB-Nedungadi merger, even here, Andhra Bank may get a branch network that is sufficiently computerized and with a baggage of NPAs. Centurion bank has a notable presence in the western region. But Integration may become a problem given the diverse backgrounds.

Again, these bailout mergers may end up burdening the healthy banks affecting their future performance. Consider the case of PNB. The bank was earlier involved in merger activity—one in 1986 with Hindustan Commercial Bank and other in 1994 with NewBank of India. Especially after the merger with NewBank of India, it took nearly three years for the bank to put things in the right place. Prof. Roy comments on the process of mergers in Banking sector, "merger is one option available to the Government/RBI to revive a sick bank. Bank restructuring in many ways has been attempted the world over, with mixed success and at a great cost to the exchequer. The fact is that few governments will be in any position to afford/allow a bank to close as it has considerable social, political and economic repercussions.

Mergers have been found (despite its inherent challenges) to be an effective mechanism in allowing the weak bank to continue, albeit with a new identity. It is basically to protect the interest of depositors and good borrowers (who constitute almost 95-97% of all the borrowers of a weak bank), and it is not the fault of these depositors/ good borrowers for the bank becoming weak. Merging a weak bank with a strong bank is not a short-term solution, but in effect it is a long-term solution and if

Merger of Unequals

	PNB	Nedungadi Bank (as a % of PNB)
Net worth	3,216.24 cr.	Negative
Branches	4268	4.1
Deposits	64,123 cr.	2.2
Advances	34,369 cr.	2.2
Net NPAs	1,810 cr.	13.2
Income	7,734 cr.	2.9
Profit	562 cr.	0.2

As of Financial Year 2002

Compiled from www.finance.yahoo.com

> **The aggrieved shareholders in a merger have all the rights to appeal to SEBI along with recourse to legal action, including bringing a stay on the merger.**
>
> **Prof. D Ghosh Roy**
> *Director, BDP Consultants, Pune*

ffectively managed it is also heapest in terms of the cost of rotecting the interest of depositors nd good borrowers of the weak ank. Merger of a weak bank needs o be looked into from this erspective."

'ublic sector banks: Burdened y social responsibility

Aore often it has been observed hat public sector banks have been ctively involved in mergers with rivate sector banks (See Box: Aerger Mania). Public sector banks re often criticized for not mproving their performance but on he other hand they are expected to ailout sick banks. There is no roblem if the merger is value nhancing. But have all mergers een in this sector accomplished his same purpose? No one except he banks involved in these nergers can throw light on this spect. But Prof. Roy says, "Out of he 22 public sector banks at least 5/6 of them are doing quite well. These strong public sector banks ave the social as well business esponsibilities to take over weak anks as a long-term usiness proposition nd also to protect the nterest of innocent epositors and good orrowers of the weak anks. A properly anaged merger is more cost- effective and a better mechanism to protect the interest of the innocent depositors and good borrowers of the weak bank."

In the long-term, mergers may not be a permanent solution for the sick banks; they need to make concerted efforts to enhance their productivity to sustain in future

Many banks are failing to understand the requirements of the changed environment where competition is on rise from foreign banks, and where there is a great need in the change of management policies for their survival. Financially sound banks; particularly the Public Sector Banks can no longer afford the bailout mergers even if they have the social responsibility of taking care of the depositors and employees of these sick banks. These banks have to take care of the increasing competition, respond to the peer pressure to perform better, have to make heavy investment in Information Technology, and take measures to reduce NPAs level. These measures have to be given priority rather than undertaking the burden of rescuing other banks. Of course as said earlier, value-enhancing mergers are welcome, but one has to take care of the risks inherent in the mergers of unequals.

In the long-term, mergers may not be a permanent solution for the sick banks; they need to make concerted efforts to enhance their productivity to sustain in future. Prof. Roy opines, "Any economy, including that of the USA and other developed countries, (Refer Andrew Sheng (Ed), "Bank Restructuring: Lessons from the 1980s", The International Bank for Reconstruction and Development, Washington, D C, available in India from Allied Publishers Limited) will experience (and are experiencing) banks becoming weak and also noticing failure. India, in a globalized scenario, will not be an exception. This phenomenon of banks becoming weak and also failing has to be understood in this context. In USA every year few hundred banks close down. The economy and the marketing culture and environment in USA are in a position to withstand such bank failures.

India today at its development stage cannot afford this, particularly if the bank is old and has a considerably large community base. Here, the merger will remain a cost-effective strategy to protect the interest of innocent depositors and good borrowers for sometime to come, till the economy and environment matures enough to take bank failures into its stride." ❍

Shashidhar Mishra

Reference # 1-2003-01-05

Merger Mania:
List of Public Sector and Private Sector Banks Involved in Mergers

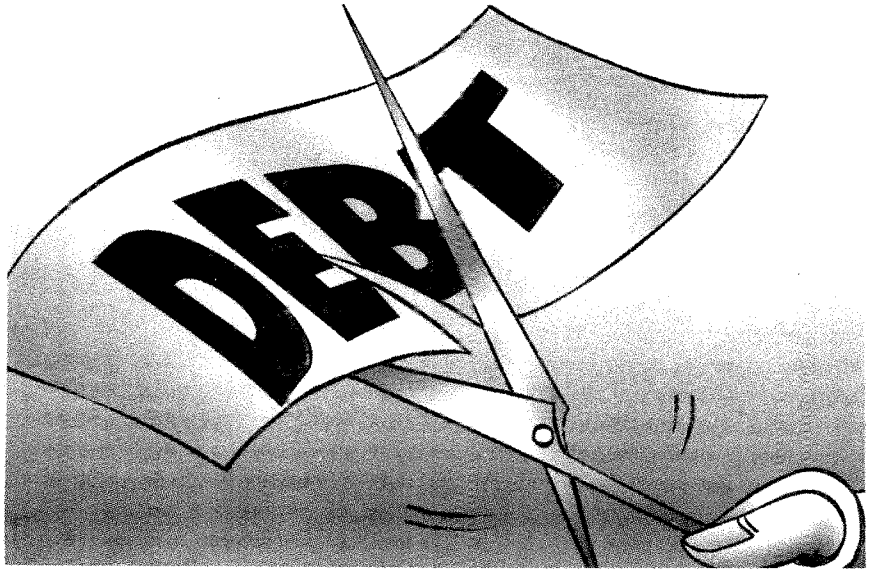
Public Sector Bank	Private Sector Bank that was merged
Allahabad Bank	United Industrial Bank
Indian Bank	Bank of Tanjavur
Bank of India	1. Paroor Central Bank 2. Bank of Karad
Bank of Baroda	1. Barelly Corporation Bank 2. Benaras State Bank
Indian Overseas Bank	Bank of Tamil Nadu
Union Bank of India	Sikkim Bank
State Bank of India	1. Kasinath Seth Bank 2. Bank of Cochin
Oriental Bank of Commerce	Punjab Co-operative Bank

Source: ICFAI Press Research Center

CORPORATE DEBT

Getting unburdened

A majority of companies in India, led by MNCs are offloading their debt. Interestingly, they are retiring their debt in a scenario where funds are available at cheap rates. What is prompting them to offload their debts?



In the spate of current economic and business evils, if there is anything that is favoring the corporates it is the falling interest rates. However, companies are not using this opportunity to provide cheap funds for future investments. Surprisingly, companies, especially, MNCs are using this opportunity to retire their debt at the cost of fixed asset accretion hampering their future growth prospects. This has resulted in drastic reduction of debt-equity ratios of companies. The balance sheet data available for 1,000 companies for the year 2001-02 reveals that the debt-equity ratio for around 60% companies has shown a downward surge. Table 1 shows that the debt-equity ratio of most of the MNCs has decreased by a large extent when compared to the previous year. For instance, Whirlpool's debt-equity ratio has fallen to 1.67% in 2002 from a massive 3.27% in the previous year. Similarly, consider the case of Wockhardt. The company's debt-equity ratio has decreased to 0.15% in 2002 from 0.62% in 2001. ITC too has reduced its bank borrowings by Rs. 580 cr. Gillette has reduced its debt by Rs. 60 cr.

What lies beneath?

What could be the reasons for such a trend? Companies wanted to utilize the opportunity of low interest rate regime to swap with their existing high cost debt. This results in the savings on the interest front and lower interest costs would proportionately inflate their profit margins. Says Professor M S Narasimhan, Indian Institute of Management, Bangalore, "With the falling interest rates, it doesn't make sense for companies to keep high cost debt and hence some repayment is taking place." An empirical study conducted on a sample of 208 companies covering a span of eight years between 1975 and 1986 has revealed that there is a negative correlation between growth rate of EBIT and debt levels.

Another important reason behind this move is increasing dependence of companies on the internal sources for their funding requirements. According to Narasimhan, "As on March 2002, the median current ratio of foreign firms with debt-equity ratio of less than 0.25 is 2.23. This is against a current ratio of 0.86 for foreign firms with above a debt-equity ratio of 1." A close look at the companies' sources of funds (Table 2) reveals that current liabilities have contributed to around 81% of total funds in the fiscal 2001-02, when compared to the previous year's 20%. This implies that companies are relying on internal sources to meet their short-term requirements and are utilizing the long-term funds to retire the existing debt. A huge rise in the sources of funds from current liabilities and provisions indicate that a lesser amount of long-term funds is invested in short-term; this frees extra sums, thus making larger sums available for prepayment of debt.

Though it is an acceptable fact that debt is an important source of capital and forms an important component of capital structure of company, excessive dependence on debt is not palatable. Increased burden of debt indirectly affects the market value of the company. While there are arguments saying that market value of a company depends on the investment decisions made by the company rather than the sources of investments, the psychological mindset of investors does not concede to this. If a company is highly leveraged, investors see a large portion of revenues being

Table 1: Debt-Equity Ratio (Million Tonnes)

Company Name	2002	2001
Bayer (India) Ltd.	2.04	2.53
GlaxoSmithkline Pharmaceuticals Ltd.	0.02	0.09
ITC Ltd.	0.07	0.25
Gillette India Ltd.	0.45	0.78
Larsen & Toubro Ltd.	1.09	1.09
Novartis India Ltd.	0.05	0.57
Philips India Ltd.	0.42	0.76
Thomas Cook (India) Ltd.	0.34	0.6
Whirlpool of India Ltd.	1.67	3.26
Wockhardt Ltd.	0.15	0.62

Source: CMIE

directed towards the debt holders and feel highly risky. This feeling refrains them from buying the company's stock, setting a bearish trend to the company's stock. This leads to a decrease in the company's stock price and in turn would lead to a decrease in the market capitalization of the company. In these tough times, to keep the market capitalization and investors confidence up, companies need to offload their debt.

When compared to a firm, which is less leveraged, a firm with a high leverage would definitely face high agency cost. The reason being, highly leveraged firms are featured by large number of creditors who oppose the decisions taken by the company's management, in anticipation of losses. Also, firms may retire their debt, in order to get a better rating from the credit rating agencies. A company with low debt component in its capital structure obviously gets good rating.

Followed by threats...

Is prepayment of debt a wise move? Perhaps not. By swapping their existing high-cost debt with the funds available at low interest rates, companies are foreseeing only short-term benefits and are ignoring the long-term threats. In other words, with an intention to increase their profits in the short run companies are foregoing their future growth prospects. Companies are utilizing the funds available at cheaper rates to prepay their debt, rather than to invest them in new areas. This is evident from the spending patterns of the companies. Aggregate expenditure on loan repayment has grown by nearly 57% from Rs. 13,279 cr in 2000-01 to Rs. 20,903 cr in 2001-02. Investment in fixed assets has declined by 13% from Rs. 7,396 cr to Rs. 5,995 cr. Consider the case of ITC. The company has increased its cash outflow by 5.7% from 7.1% in 2000-01 to 12.8% in 2001-02. The funds used for loan repayment have increased by a massive 170% from Rs. 265 cr. to Rs. 715 cr. On the other hand, the share of purchasing fixed assets has declined from 12.5% of the aggregate of the cash outflow to a mere 9.2%.

Table 2: Funds Flow

Sources of Funds	1997-98	1998-99	1999-00	2000-01	2001-02
Internal Sources	32.1	42.9	50.6	48.3	25.8
External Sources	67.9	57.1	49.4	51.7	74.2
Capital Markets	20.2	17.0	17.4	30.7	-3.2
Borrowings (Exd FD, Deb)	30.8	18.3	9,.6	11.2	-4.1
Current Liabilities and Provisions	16.8	21.7	22.4	19.8	81.6
Uses of Funds					
Gross Fixed Assets	63.8	73.5	53.9	53.6	48.9
Inventories	9.6	4.2	17.3	20.9	16.9
Investments	26.7	22.3	28.8	25.5	34.2
Cash & Bank Balance	5.4	0.8	5.5	-2.1	11.7

Source: CMIE

> **With the falling interest rates, it doesn't make sense for companies to keep high cost debt and hence some repayment is taking place.**
>
> **M S Narasimhan**
> *Indian Institute of Management Bangalore*

Companies enjoy the fruits of dependence on the current liabilities only to the extent where they are able to raise funds at cheaper rates and have optimal credit lines with the lenders. But once these sources get exhausted, their liquidity position will be badly affected. In addition to this, since the economy is in a recessionary phase, companies don't have investment avenues in the short run and as a result of this they are able to utilize the funds available in prepaying debt. Once the economy recovers, the companies cannot proceed with the same practice as they need to utilize the funds to invest in the business.

Even if we presume that companies have shown this dramatic trend as a result of the existing circumstances, everyone is hoping of a better tomorrow in terms of both economic and investment scenario. Though this move has been profitable as a result of the present economic scenario, companies can't utilize this strategy in the future. This requires companies to make themselves compatible for the future and frame strategies accordingly.

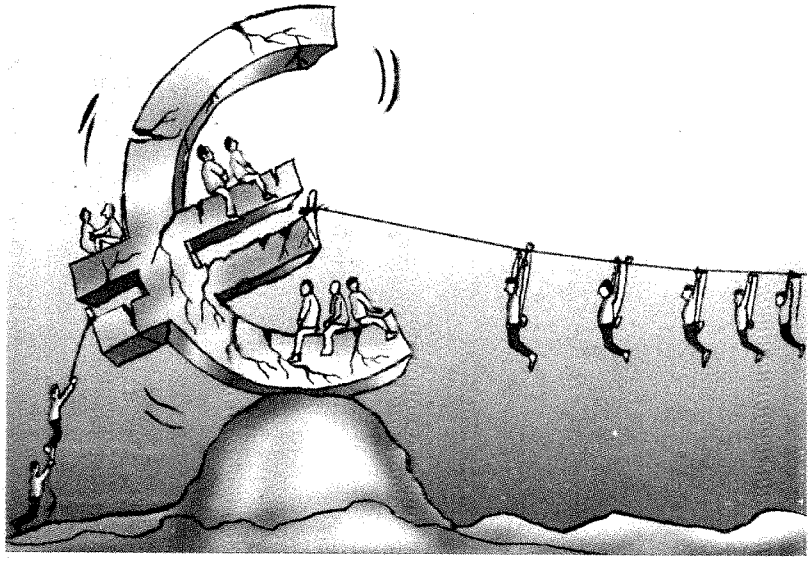
Sharath Jutur

Reference # 1-2003-01-06

EUROPEAN UNION

Problems galore?

Soon 10 new countries will enter the European Union to form Mega Europe. The size of the Mega Europe will be $9.3 tn and the population will increase to nearly about 450 million. But with European Union's existing problems, will the entry of the new countries into the European Union be smooth?



The idea of European Union (EU) was proposed in 1950, by the then French Foreign Minister, Robert Schuman. Initially only six countries (Belgium, Germany, France, Italy, Luxembourg and the Netherlands) joined to form European Community, which was later transformed into EU with the joining of other European countries.

Recently, European Commission (EC) announced that 10 new countries: Poland, Czech Republic, Hungary, Slovakia, Lithuania, Latvia, Slovenia, Estonia, Cyprus and Malta would join EU by 2004. Some of the member states within EU and critics are upbeat about EU's enlargement. According to Romano Prodi, President, European Commission, "enlargement is a way to better confront the huge productive capacity of China, a way to confront the US economically." Once the new countries join, EU would become the world's largest integrated economic market. The EU economy would grow by an additional 0.2% a year as a result of enlargement. However, others are doubtful about the benefits. Jules Maarten, a Dutch member, European Parliament, says, "I don't think we can deal with a big-bang expansion."

Problems in EU

The most contentious issue: Though EU has contributed to the development of peaceful relations between European countries, it does have problems. According to Ramûnas Vilpisauskas, Senior Policy Analyst, Lithuanian Free Market Institute, the most contentious issue is the Common Agricultural Policies (CAP). It constitutes 45% of the total EU budget. Previously, farmers within the EU were guaranteed high domestic prices. In addition, export subsidies were given to the farmers and levies were put on imports of farm products. Taking advantage of that, farmers used to produce excess quantity of agricultural products in cereals and dairy. As a result, EU was forced either to store excess food or dump the excess quantity in the world markets at a much lesser price. EU also had to take the additional burden of compensating the farmers for the difference between higher European and lower global prices. This resulted in ever expanding farm budget of EU, which became unsustainable.

In order to put a cap on the spiraling farm budget, reforms were carried out in CAP in 1992. Under the new CAP, guaranteed prices paid to the farmers were reduced. Instead, farmers were paid compensation in the form of new subsidies. The new subsidies, in the form of aids were paid directly to the farmers. However, reforms in CAP affected only a limited number of crops, mostly cereals. EU continues to support the export subsidies for other agricultural commodities, such as diary, beef and sugar, and processed foods made from milk and sugar.

Still EU has to pay $39 bn a year in direct subsidies to the farmers. To reduce the huge cost, Franz Fischler, EU's Agricultural Commissioner, proposed further reforms in CAP in July 2002. Fischler is of view that instead of subsidies, farmers would be paid flat payments, which would be gradually cut back over time with the money being redirected towards rural development. This arrangement would also 'decouple' payment from production. However, some countries such as France and Spain who benefit most from the current direct payments system are against the gradual phase out. However, Vilpisauskas

comments, "CAP has been based on political motives of ensuring high standard of living to EU farmers rather than economic reasoning."

The funds problem: The Structural Funds constitute the second largest component of the EU budget. These Funds have been instrumental in addressing the concerns of the member states. Even pet projects of various Members of European Parliament are funded directly from the administrative section of the budget. The usage of these Funds have also led to bickering between different member states.

The EU largesse on providing funds to every and any small project, placed a huge burden on the EU budget. In order to reduce the burden and streamline the process of disbursement of Funds, the Commission came out with certain proposals in its Agenda 2000 under which 66% of the Funds would go to regions that have a per capita GDP of less than 75% of the EU average. This is termed 'Objective 1'. Under 'Objective 2', EU would support wealthier regions that faced development problems due to structural change. This would account to near about 10% of the funds. 'Objective 3' deals with labor market policy targets without regional focus, which accounts for 13% of the funds, while the remaining Funds accounted for 'community initiatives'. Though every member state agreed to the proposal, some countries still continue to seek more cash for particular regions and subregions.

There is also considerable difference in the amount contributed by different countries to the EU budget. Germany which always had been the largest contributor to the EU budget, wants to cut its contribution. Other major contributors are Netherlands, Sweden and Austria. These countries support the idea of curtailing spending on existing EU programs which contribute less to the overall betterment of the EU. However, countries such as Spain, Portugal, Ireland, Greece and France who are main beneficiaries from the present form of budget allocation and spending vehemently oppose any cut in the spending.

There is another problem regarding the use of Funds. The major contributors cannot directly control the use of the Funds. They have to rely on the Commission to ensure a correct implementation of the Funds. However, a conflict of interest arises between them and the Commission, as the Commission has its own interests that are not necessarily always in line with the efficient use of the Funds. In addition, a EU Cohesion Fund was introduced in 1993 to support the poorer member states in upgrading their transport infrastructure and the environment. This is considered as an indirect budgetary aid in order to facilitate the process of integration into the European Monetary Union (EMU) and to cope with the demanding fiscal and monetary criteria of EMU. However, the desired effects have varied considerably among the member countries. Apart from Structural and Cohesion Funds, there are many more exogenous variables that determine a process of convergence and cohesion.

Currency and stability problems: Though the euro has been successful with low inflation rate prevailing within EU, it failed in propelling growth in the European economy.

Taxation obstacles: Another problematic issue is the taxation policies of the EU. In order to stop unfair tax competition, EU needs corporate tax reforms. The European Commission announced recently that an agreement has been reached by the 15-member states of the EU for a consolidated tax base for the EU-wide activities of companies in that region. But still certain obstacles remain, such as differences in the tax rates in various member countries.

The Commission has also recently presented a proposal on the harmonization of the laws, regulations and administrative provisions concerning credit for consumers. The intent is to "pave the way for a more transparent market, a more effective market and to offer such a degree of protection to consumers that the free movement of offers of credit can occur under the best possible conditions both for those who offer credit and those who require it." But, financial institutions regard the proposal on its present terms as a threat to development and expansion of their business. On the other hand, though consumers have welcomed the proposal, they are skeptical about the effect on the level of consumer protection that the new proposal would achieve. Besides, certain other issues also need to be sorted out.

EU's unique organizational structure–A problem: EU is a unique organization, as it is not a new State replacing the existing countries in Europe. Rather, EU is built on an institutional system. The core of EU consists of European

The most controversial issue in the longer term is going to be a reform of the Common Agricultural Policy, which has been based on political motives of ensuring a rather high standard of living for EU farmers rather than economic reasoning.

Ramûnas Vilpisauskas
Senior Policy Analyst, Lithuanian Free Market Institute

Commission, which upholds the interests of the EU as a whole; Council of European Union, which is the EU's main decision-making body; and the European Parliament, which is elected every five years by the European citizens. The core is flanked by other institutions, bodies and agencies. All these institutions share power with the member states. No one institute is in charge and hence is not in a position to give orders to the rest of the organization. No decisions are taken unless a broad coalition of institutions and governments agree to it, because of which decision-making in EU is slow. In addition, the member-state which holds the EU presidency, rotates every six months, which creates leadership problems. Who would act as the leader of EU, the rotating EU president, the Commission or the Council? With every six months a new member-state taking the role of presidency, both people and priorities change. Each new president pushes his or her own pet projects and may also pursue his or her national interests. As a result, there is a lack of continuity in its external representation towards countries outside the EU. In addition, EU's credibility suffers when a small country holds the post of presidency.

Implications of enlargement

On the enlargement issue, different views have been put forward. According to Vilpisauskas, "the enlarged area would contribute to EU's economic growth, new trade and investment opportunities." The growth rates of the top five candidate countries such as Czech Republic, Hungary, Poland, Slovenia and Estonia were very high. The average growth rate of these countries between a period of 1995-1999 was 3.4% compared to EU's 2.4%. The enlargement would also increase the market size of EU to $500 mn. The economy of enlarged EU would be $9.3 tn, very near to that of the US. He adds, "countries which trade most with candidate countries and are closest in geographic terms such as Germany, Austria, and Scandinavian EU members will benefit most." According to a study by the Center for Economic Policy Research, Germany alone would account for about a third of the total EU-15 gain of €10 bn from the enlargement. "This is a dawn of a new era," says Lithuanian President Valdas Adamkus.

To qualify for the membership in EU, the candidate countries had to privatize the state-owned assets, deregulate markets and restructure its industries. They also have to incorporate 80,000 pages of complex EU law in their own legal systems. These countries also have to phase out big tax breaks which they give to multinational companies for FDIs to comply with the EU rules. On the other hand, attracted by the candidate countries' cheap and educated labor and proximity to the EU, companies from the existing members of EU has invested more than $80 bn in the candidate states.

Dario Castiglione of University of Exeter, commented that it is very difficult to predict the precise economic dynamics of the enlargement. Katinka Barysch, Chief Economist, Center for European Reform, opines, "in economic terms, the accession will not matter much for the current member states. Taken together, the new members amount to just 5% of the current EU's GDP. Though the candidate countries economies have started to converge with the EU, the progress is slow. Even at a very high growth rate, it would take around 15 to 20 years for the candidate countries to catch up with the existing members of the EU.

All 10 applicants for EU membership are already making preparations to join the monetary union. However, the most advanced Central European countries face

> **"It is difficult to predict the precise economic and political dynamics of enlargement."**
>
> **Dario Castiglione**
> *Department of Politics*
> *University of Exeter, UK*

substantial obstacles in their attempts to converge with the euro-area. Real convergence is likely to take much longer, as it is much more than simply meeting the formal Maastricht targets on inflation, interest rates, public debt and fiscal deficits. Once they join the EU, new members would have to coordinate their economic policies with existing member countries, submit convergence programs, avoid excessive deficits, and later participate in the exchange rate mechanism. This means the candidate countries need to adopt the same kind of fiscal and monetary discipline as existing euro members. However, the fiscal deficits as a percentage of GDP is very high in these candidate countries compared to the EU average, which is less than 2%, which might further delay the accession to the single currency (euro). Budget deficits in Hungary and Czech Republic which have attracted high FDIs are 5% and 4.5% respectively. To comply with the 3% rule, the candidate countries need to adopt steep austerity policies. But so far only Hungary has made any progress for meeting the terms of the Pact.

Pitfalls also exist in other areas. EU budget is already under severe pressure from the existing grants and subsidies to the member countries; there is every possibility that it might exceed its budgetary limits with the enlargement. The candidate countries are saddled with a large number of unemployed people and improper infrastructure,

which means EU budgets on regional aid and agriculture would be stretched. Poland has around 2 million farms, which employs 4.3 million people. The candidate countries would receive far less regional aid under Structural Funds from EU compared to Spain when it joined EU few years back.

On the agricultural front, EU would be under tremendous pressure. Though its initial proposal of not extending the direct payments to the farmers were rejected by the candidate countries, EU still had to pay an amount equal to 25% of the level of direct payments paid currently to the farmers of the member countries. The amount would then be steadily increased to 100% by 2013. The Dutch Government has recently cautioned that if the CAP was not reformed before the EU admits 10 new members, direct payments to the farmers would increase further from the current €40 bn to €60 bn. As a result, the enlargement would cost EU $40 bn in the form of grants and subsidies out of the annual budget of $97 bn between 2004 and 2006.

Though, in order to qualify for the membership, the candidate countries had to privatize state-owned assets, deregulate markets and restructure its industries, privatization has been stalled in some candidate countries. In Poland, the Government still maintains control or majority stakes in more than 3000 companies. Uncooperative labor unions are also demanding more concessions from foreign investors. As a result, the accession of the candidate countries into the EU might take much more time (2005) than expected. Some doubt that EU should have reformed its taxation system before embarking upon the enlargement.

Outlook

Those who are against the EU enlargement viewed that EU first needs to sort out its existing problems, such as Common Agricultural Policies (CAP) and tax problems. They are skeptical that the integration of the candidate countries would also further strain the EU's institutions, and its budget. Expansion could leave Europe with high unemployment and anemic growth. The candidate countries are already struggling to implement the existing EU legislation and to prepare their economies fully for competition in the single market. Accession is also a major challenge for the candidate countries.

On the other hand, Barysch says, "the enlarged EU will be more diverse and therefore needs more flexibility. Decision-making will be characterized not by permanent alliances (such as Franco-German axis) but by shifting coalitions that form around individual issues." Some feel that enlargement threatens to make EU ungovernable and also leads to more slow decision-making.

On the other hand, Vilpisauskas opines "enlargement of the EU will not create new problems, but will rather bring up old problems of the EU such as expensive and distortionary CAP, too rigid regulatory rules or discrimination of outsiders who are not members of EU." However, Castiglione feels that the benefit of enlargement would depend on the kind of political and economic forces that would try to shape it in the next 5-10 years, and in which direction vis-a-vis the member states. With so many existing problems, uncertainty and diversity, will Europe be able to digest the enlargement?

In order to meet the complex decision-making procedures and the challenges posed by enlargement, Barysch comments, "the convention will have to come up with good solutions on how to make the EU more transparent and more democratically accountable. It needs to do its homework properly. It needs to reform its institutions and decision-making procedures. It needs to take time to digest and consolidate its grand achievements over the last decade: The single European market, the euro, enlargement and the common foreign and security policy." Though Vilpisauskas agrees with what Barysch has said, he also says that "there is no need for a radical institutional reform of the EU, because its principles (for example, subsidiarity, respect for human rights, traditions of each member, proportionality in regulating economic activities in the internal market) ensure the balance between the interests of EU members and achieving EU objectives. The main challenge is to apply the principles of the EU practice, rather than reform the Union as a whole." Castiglione says, "there is no doubt that enlargement is a challenge that cannot be met without some fundamental change at the European level." But, former Czech Republic Prime Minister Vaclav Klaus opines, "The European social economy is a tragic mistake and there aren't strong forces trying to dismantle it."

> **"Many people still assume that an EU of 25 will look just like the current EU, only bigger. This is questionable. The enlarged EU will be a different political animal."**
>
> **Katinka Barysch**
> *Chief Economist, Center for European Reform*

The question is whether Europe by pursuing reforms and working unitedly becomes a diverse, competitive, high-growth region or whether by following the same lurch-and-muddle approach and working individualistically becomes a much broader social welfare state.

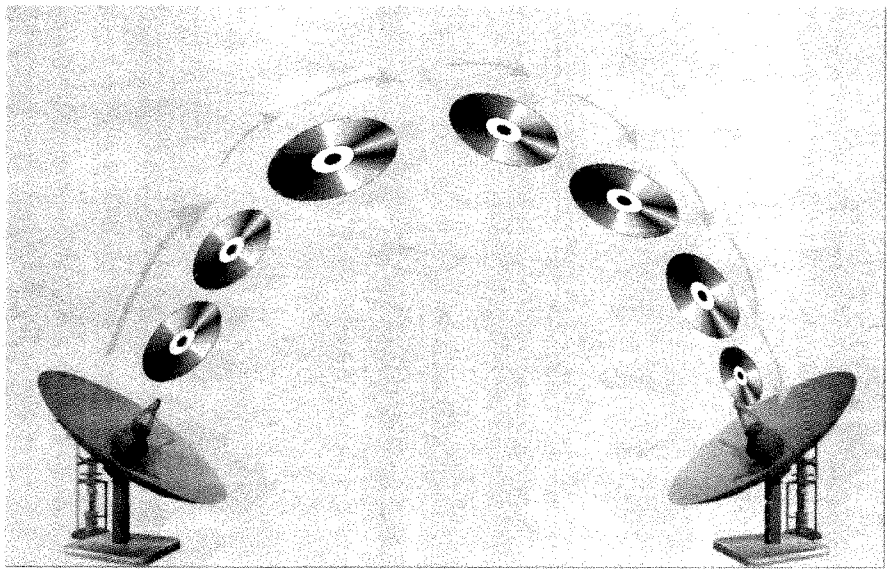
Anindya Roy

Reference # 1-2003-01-07

INDIAN IT EXPORTS

Brighter prospects

I believe that for a long time to come, this industry will offer to the world the service of its finest asset—the Indian intellect, says Suresh C Senapaty, Chief Financial Officer, Wipro Limited.



Over the last few years, no industry in India has been as much a topic of discussion and debate as the Information Technology (IT) sector. The sector has contributed much to the economy in terms of exports, employment, corporate governance, transparency and wealth creation. And even though the rate of growth has slowed down from the frenetic 50% annual growth, there is no denying the fact that this sector continues to outperform not only many other sectors in India, but also the IT services sector worldwide.

Permit me to give some statistics. The Indian IT services exports was $1.7 bn in 1997. As per the estimate of Nasscom, it is expected to clock $9.4 bn in 2002-03—an impressive 48% Compounded Annual Growth Rate (CAGR). During the same period, the global IT market has been growing at steady but slow 6% CAGR. The fact clearly implies that as a sourcing base for IT services, India has been enjoying considerable competitive advantage.

It is on this growth aspect that I would like to focus upon. The industry has seen three distinct phases of activity and I would like to address it in the same order. I would like to dwell upon the factors that put India on its growth path in the past, what is the scenario in the marketplace today and what are the key challenges for the future.

Phase 1: Capitalizing on Indian intellectual talent – The last decade of the last millennium

The first phase, marked by strong ramp up in the sector, was clearly attributable to the vast and untapped intellectual human capital in India. The market forces driving this growth were:

- The technological impetus driven by Y2K.
- The emergence of e-com and Internet, resulting in a boom in IT spending by corporates wanting to leverage these for business results.
- Consequent to the above, the boom in demand for technology and telecommunication companies who in turn had to invest in IT to develop and upgrade their products.

Simply put, riding, as the global economy—particularly the US—was on technology fueled economic boom, the demand for IT services grew. Time to market was critical. And skills were in short supply. Global corporates began scouting for sources that were scalable. India, with its vast pool of skilled labor and a strong affinity to the English language was a logical choice. The cost arbitrage resulting from the difference in purchasing power parity between India and US of nearly 6 to 1, made the choice even more attractive. What started as a flexible-model for sourcing of intellect and manpower soon became an industry.

Indian industry met the need for rapid scaling up with the innovative Offshore Development Center (ODC) model. Sure, there were some risks associated with offshore sourcing—but Indian IT services responded to that through building strong process capabilities in global service delivery, mainly through investments in quality. Quality has been a key differentiator for Indian IT industry. As a leading IT company, Wipro was a pioneer not only in the ODC model but also invested in and built leadership in Quality. Wipro is world's first PCMM, and CMM level 5 company and has made Six Sigma Quality as a core function, focused on continuous

improvement in process capabilities across organization.

Phase 2: Current scenario in the industry

The dotcom demise, stagnation in US economy and the finally 9/11 incident. Events, which individually could cause severe setback to industry, came all at once. The initial reaction was one of shock for global corporates, resulting in a period of time characterized by indecision. As a clearer picture emerged, it became evident that corporates all over the world were in for a challenging environment for some time to come. Consequently, they realized that to survive and grow they had to invest their resources wisely. In terms of IT spends, this meant the need for better productivity and 'more bang for the buck'. As a report from the market research group Gartner puts it, "The focus of US buyers is largely on cutting costs without sacrificing quality, as well as on more disaster recovery and business continuity solutions." The report went on to add that, by 2005, four to five current Indian companies will become dominant IT service providers on a global scale.

Indian IT services industry is now viewed as a 'business-partner' instrumental in devising, creating and maintaining requirements of the corporations

Once again the Indian IT services model had come to the fore. The ability to provide high quality IT work based on a global delivery model at a competitive total cost of ownership was too compelling an argument to be ignored. This resulted in a number of global leaders looking to outsource more to Indian IT services companies.

A survey conducted by Merrill Lynch of CIOs of 100 *Fortune* 1000 companies earlier in the year clearly validated this. In an environment of declining IT spends, over 45% of the CIOs saw their spend with Indian IT vendors increase or remain flat. Over 21% of the respondents said that the outsourcing segment they would use the most would be Indian offshore segment.

These developments have resulted in offshore becoming a central theme in many a global corporation's IT strategy. Indian IT services industry, so far seen as 'valued supplier', is now viewed as a 'business-partner' instrumental in devising, creating and maintaining IT requirements of the corporations. It has opened up new segments for Indian IT services industry such as Systems Integration, Package Implementation and Total Outsourcing.

Phase 3: The future – Key is in expanding the services footprint

Nasscom, in association with the global consulting major McKinsey, has come out with a report on Indian export potential for IT services. It projects the growth potential of various market segments up to 2008. The report expects Indian IT services exports to grow from about $7.7 bn in 2001-02 to around $55 bn in 2008. This works out to a CAGR of 38%. Impressive as it may seem, one needs to look at the DNA of the growth to understand the full implications for the industry.

Customer applications, an area which Indian IT segment has been traditionally catering to and which constituted nearly 60% of India's software exports in 2001-02, is expected to grow at CAGR of 20%. If you compare it with the 48% CAGR, Indian IT industry has enjoyed in last five years, the segment is definitely showing a sign of maturity. What is interesting, however, is that the newer segments like systems integration and IT infrastructure outsourcing are projected to grow significantly at CAGR of 66% and 92% respectively; IT-enabled services are not only projected to grow at excellent CAGR of 56%, but also are expected to be biggest market segment at $21 bn.

I believe the message is clear—to continue to grow at healthy rates and to realize the potential that it has, the Indian IT sector will have to transform itself to cater to the requirements of these new segments. This transformation will come through widening the existing services skill-set—both organically and inorganically—and adopting a global mindset to manage the business even while continuing to leverage the stronger global delivery platform.

The transformation will bring with it new challenges. Challenges in integrating a global workforce. Challenges to continuously adapt to newer technology. Challenges of building and sustaining a global brand. And, most important of all, challenges of meeting the ever increasing expectations of its global customer base.

Conclusion

Indian IT services export has clearly enjoyed some fantastic growth numbers in past few years. However, with changing global business scenario, the future belongs to those who can meet the challenge of successfully blending new service offerings such as systems integration, total outsourcing and IT-enabled services with their existing service portfolio and build organizations that are global in every sense of the term.

I am very confident that Indian companies have the ability to meet these challenges. I believe that for a long time to come, this industry will offer to the world the service of its finest asset—the Indian intellect.

Reference # 1-2003-01-08

SEC

The mantle passes on

SEC has a new Chief, William Donaldson, who replaces the much-tainted Harvey Pitt. Pitt had been facing severe criticism for acting too slowly and being too soft with the accounting profession. The responsibility to restore investor confidence now shifts to Donaldson.

The last one and half years have been tumultuous for corporate America. Specifically from December 2001, when Enron went bankrupt, there has been no let up in the number of companies confessing to accounting manipulations, making restatements or going bankrupt. The scenario severely affected investor confidence; more so because of the way American capital markets are structured. Capital markets in America are characterized by widespread participation of retail investors as against a handful of institutional investors or founding family members. In such a market the key to investment choice is the information about the company. And the main issue in the Enrons and Worldcoms is that information about the company had been manipulated cleverly to disguise the truth from investors, finally leading to huge losses for them.

The market watchdog'

In such a background, the role of SEC, the market watchdog, established specifically with the objective of investor protection gains importance. But many are not satisfied with the way Harvey Pitt handled the situation. To begin, he was seen as being too close to the accounting industry; he had represented three large accounting firms and AICPA against Arthur Levitt, his predecessor on the issue of restricting non-audit services provided by independent auditors. In one of the first public speeches as the Chairman of SEC, he spoke of his aim to make SEC a kinder, gentler place for 'everyone', largely interpreted as accounting firms. He is also criticized for meeting with the top brass of firms that were under investigation such as Xerox.

There were repeated demands for Pitt's replacement from many quarters but the Bush administration had firmly stood by him all along. The issue of the appointment of the chairman of the Public Company Accounting Oversight Board, the new regulatory body put in place to oversee accounting profession brought about the end of Pitt's reign as SEC chairman. The first choice for the post was the highly respected Dr. John Biggs, CEO and Chairman of TIAA-CREF and a vocal advocate of accounting reform. But Pitt finally brought in William Webster, former chief of FBI and CIA. Pitt had failed to inform the other commissioners or even the Chief of Staff about Webster's association with US Technologies, a firm under investigation. Webster had been the director and also the chairman of the audit committee of the firm, which had dismissed its outside auditors when they pointed out irregularities in internal controls. The fact was too important to be overlooked while considering the appointment to an accounting oversight board, which was specifically created to oversee accounting profession. This was the final straw and Pitt, who had resisted resigning for a long time finally gave way and 'stepped aside'. Prof. Paul B W Miller, Professor of Accounting at Colorado University, comments "...his tenure was stormy and unproductive. It will quickly fade from memory, except to serve as a reminder that political maneuvering has no place in efficient capital markets."

Professor Donald Langevoort of Georgetown Law School observes, "the SEC was caught in a difficult political position, and that very few chairmen could have managed the difficulties well. Harvey Pitt was not adept at all at the political game. The key, however, is whether the SEC's response to the scandals would have been proportionate to their severity."

Donaldson, the new face

The Bush administration has nominated William Donaldson as the new Chairman, whose appointment needs to be approved by the Senate in January. But for now, he is considered as a well qualified candidate. Donaldson had founded an investment bank, Donaldson, Lufkin & Jenrette (now part of CSFB), founded the Yale School of Management, acted as the chairman of New York Stock Exchange and was also a former undersecretary of state. He has a deep understanding of the various intricacies of the capital markets. He had foreseen the conflicts of interest in Wall Street firms much before they came to the fore. He was quoted in *New York Times*, 12 years ago, saying, "Firms have to have a clear idea of whether they are dealing for themselves or for their customers. It's when you try to be all things to all people that you get into trouble." It is largely expected that his candidature will be approved. His main responsibility would be to put reforms on the fast track, step up the efforts to fill the Public Company Accounting Oversight Board since Webster too followed Pitt. Restoring investor confidence would be his main challenge.

D G Prasuna

Reference # 1-2003-01-09

SEC

Under Harvey Pitt

The tenure of Harvey Pitt was stormy and unproductive. It will quickly fade from memory, except to serve as a reminder that political maneuvering has no place in efficient capital markets, says Paul B W Miller*, Professor of Accounting, University of Colorado, USA.

Unquestionably, the SEC has acted in the best interests of investors during the last year and a half. It has acted in the best interests of investors ever since it was established in 1934. The agency is far more than its commissioners, and certainly far more than the person who is put in the chairman's seat. The people of the SEC are trustworthy and hard working. They do the best they can with the tools put at their disposal.

The tenure of Pitt

Sometimes, as in the last year and a half, the agency is handicapped by a lack of proper leadership. Pitt was unable to provide any leadership. For one thing, he was a known quantity, and what was known about him did not inspire the people of the SEC to implement his policies with enthusiasm.

He was tainted from the beginning in that he was appointed as a political pay-off, I believe, in return for more than $1 mn in contributions from the accounting firms and the American Institute of Certified Public Accountants to the presidential campaign. The people of the SEC were totally aware of this situation.

He was further tainted because he had represented three of the large accounting firms and the AICPA in the battle of 2000 against former Chairman Arthur Levitt's effort to restrict the kinds of non-audit services that could be provided by independent auditors. His actions were remembered and surely inhibited his ability to lead the very agency that he had hammered into submission with heavy-handed political maneuvering and *ad hominem* attacks on Levitt and the SEC staff.

In addition, he seems to have brought with him an extraordinary amount of poor judgment. One issue after another seemed to follow in his wake, including the number of cases in which he was involved. The most bizarre was his willingness to meet with representatives of an accounting firm that was under investigation.

The final blow came during the last days of Pitt's efforts to put together the new Public Company Accounting Oversight Board (PCAOB) that was created by new legislation passed in the summer. He was given the task of identifying the individuals to occupy these high-paying government positions to exercise control over those accountants who audit public companies. He had discovered an excellent candidate to chair the board, Dr. John Biggs, the CEO and chairman of TIAA-CREF, the largest private pension fund in the US, and perhaps the world Dr. Biggs has extraordinary experience, not only as an investor but as a participant in accounting regulation through his service, for example, as a trustee for both the FASB and the IASB. He was a popular choice with everyone, except for those in leadership in the remaining four firms and the AICPA. I believe that they induced Congressman Michael Oxley to speak on their behalf against Dr. Biggs, condemning him, strangely enough, as being too inclined toward actually reforming the accounting profession.

Pitt's defining moment had come. On one hand, he could stand with the spirit of the law and rally the SEC to his leadership by remaining loyal to Dr. Biggs and advance his nomination for a vote by the full commission. On the other hand, he could simply be another political hatchet man and follow the bidding of those who put him into his office, even if it meant doing what was wrong for the capital markets, the accounting profession as a whole, the PCAOB, and the SEC itself.

As the investing world knows, he took the lower road and cast aside the Biggs nomination in favor of a familiar Washington face, William Webster. Unfortunately for Pitt, he put all his eggs in the Webster basket, which turned out to be unsuitable because of his involvement with a company that was under investigation for accounting fraud.

More poor judgment by Pitt followed as he kept this information from his commissioners and forced a vote. Webster was approved, but only by splitting the commission along party lines, a virtually unprecedented outcome. When the full story was released, Pitt and Webster both resigned, as well as the SEC's chief accountant, who is arguably the most powerful accountant in the world.

In summary, investors were protected during the Pitt chairmanship, which, incidentally, still continues because he has not yet left the SEC.

Were the investors as well protected as they might have been? Probably not. The tenure of Harvey Pitt was stormy and unproductive. It will quickly fade from memory, except to serve as a reminder that political maneuvering has no place in efficient capital markets. Incidentally, no one can 'reign' over any agency of the Federal Government. The institutions define themselves rather than being shaped to fit the mold of those who are appointed to head them.

Pitt and the accounting profession

There is more than an element of truth that the Pitt chairmanship was preordained to be a failure, not merely because of his previous relationships with various individuals and institutions. It was doomed from the beginning by his lack of individual character and commitment to advance the interests of the populace (of the United States and the world at large) over what he perceived as his own interest in serving those who put him into power.

History will show that he failed because he had inadequate character, not because of what he had done before coming to the Commission. As to the question of whether he was too soft, I suppose that the argument could go both ways. Could he have been harder? Yes. Could he have been softer? Yes. Could he have been a more effective leader? Absolutely.

His departure had the effect of boosting investor confidence, at least among those investors who consider the SEC to be relevant. Even though uncertainty follows when a key leadership position is vacant, I believe that many were buoyed by the fact that the vacancy indicated the end to a short period of tremendous ambiguity as to who was being protected by Pitt.

Regulatory bodies

The message is clear. The old way of regulating markets is coming to an end. Political maneuvering will not work to force efficient markets to act contrary to their own interests. Further, there are severe limits on what any regulator, whether Pitt or Levitt, can do to impact the capital markets. They are huge and have a life of their own. They are not mere horses to be driven here and there by a tug on the reins. They have a huge power of their own that not even the mighty US Federal Government can overcome.

Thus, the markets surely shrugged off the political comedy and are now awaiting the next move by the Bush administration to bring some order to the government's involvement in the capital markets. As I am writing, we are absorbing the generally welcome news that the President will also be appointing a new secretary of treasury and a new economic adviser, as well as choosing a new head of the SEC helm. (The new SEC chair will also appoint the chair of the PCAOB and a new Chief Accountant.) There is every reason to be hopeful that good choices will be made.

The lesson was learned by more than Pitt. The futility of political machinations was surely observed by the Bush administration. Further, it had the effect of stripping away the accumulated political influence of the large accounting firms and the AICPA. Although they gave away large sums of money to win influence, it has all been drained away and cannot be readily replaced, if ever.

In this sense, public financial reporting is poised for perhaps the season of greatest reformation that it has ever experienced. This is an exciting time.

Through the crystal ball

The SEC's future remains bright. It is a good agency with a proud and responsible staff. It has seen chairmen and commissioners come and go. If anything, these events are likely to have stiffened the staff's resolve to do their jobs better than ever.

The status of the PCAOB is a mystery. Already, it is out of compliance with the enabling legislation, which required that its members be appointed and serving by the end of October. Without a good hand on the helm, nothing will be accomplished, which is, I suppose what the accounting profession's leaders would like to see. On the other hand, my optimism leads me to project that it will eventually take shape and accomplish some small reforms. If Dr. Biggs were to be appointed, which seems unlikely, I think the chances of larger reforms are greater.

I cannot close without offering some insights offered by the new paradigm that I describe and advocate in *Quality Financial Reporting* (McGraw-Hill, 2002). The essence of the QFR paradigm is that regulation will never be enough to create safe and efficient capital markets. The regulatory system, including the SEC, FASB, and IASB, is inherently political and unable to lead the art and science of financial reporting to higher levels.

That power is, however, inherent in the incentives offered by the capital markets themselves: (1) more complete, reliable, and trustworthy information reduces uncertainty, (2) reduced uncertainty decreases investors' risk, (3) less risk produces satisfaction with lower rates of return, and (4) a lower rate of return is a lower cost of capital and a sure stimulus for higher stock prices.

Thus, it is a mistake of monumental proportions to believe that any regulatory system (with or without Pitt) could ever protect capital market system any better than the system can protect itself.

**Served on the staff of the Office of the Chief Accountant of the SEC, as well as the staff of the Financial Accounting Standards Board.*

Reference # 1-2003-01-10

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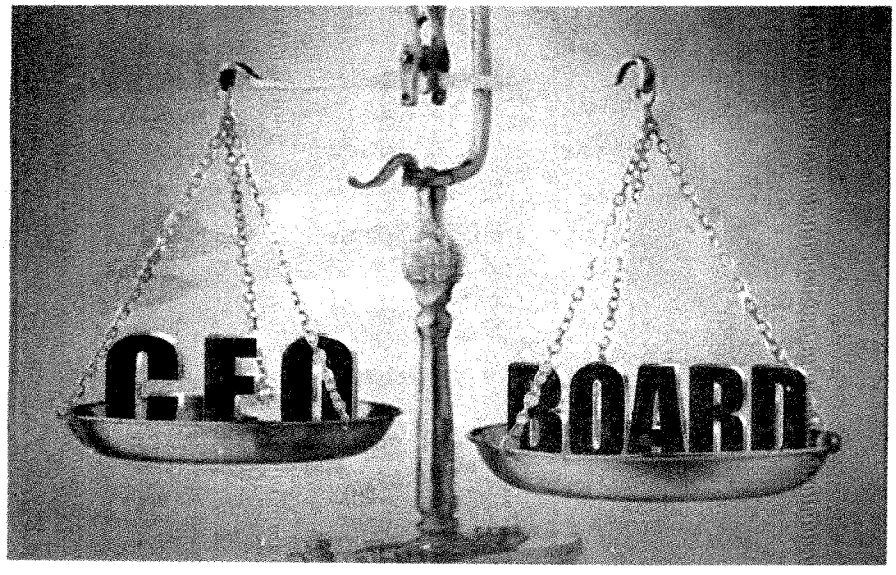
CORPORATE GOVERNANCE IN INDIA

Improving standards

Indian companies are realizing the significance of implementing corporate governance practices. As many companies realize its importance, good corporate governance could be on the rise in India.



After accounting scandals in companies like Enron and WorldCom, corporate governance practices have become a major concern across the world and India Inc. is no different. A gamut of measures aimed at improving corporate governance standards are underway in India currently. The Confederation of Indian Industries drafted a desirable code of corporate governance in 1998 and since then many organizations such as Institute of Company Secretaries of India (ICSI), Securities and Exchange Board of India (Sebi), Department of Company Affairs (DCA), and credit rating agencies ICRA and CRISIL have been making serious efforts to increase the awareness of good corporate governance practices in the country. Of late many companies have realized its importance and few have got their ratings done from these agencies. Murali Patibandla, Associate Professor at Department of International Economics and Management, Copenhagen Business School, Denmark says, "Corporate governance practices have improved compared to five or 10 years with companies like Infosys clearly showing the benefits of good corporate governance."

The corporate vigor

There is a gap in understanding the present situation in corporate India and the desired level of the same regarding corporate governance. One of the best ways to bridge this gap is to encourage lot of research and studies in the country for the same, provide a platform to generate and share knowledge on the subject. Many initiatives have been taken in this regard. Dr. Y R K Reddy, Chairman, Yaga Consulting Pvt. Ltd., founded the Hyderabad-based Academy of Corporate Governance where directors and professors of IIMs—Ahmedabad, Bangalore and Kolkata, Administrative Staff College of India and authorities in different areas in the US, New Zealand, Malaysia and South Africa are associated with the academy. The DCA planned a course aimed at training the directors of companies for corporate governance earlier in 2002 and is currently planning to create a national institute of corporate governance.

Sebi has proposed ratings of corporate governance practices. Two agencies ICRA and CRISIL have come forward with their specific ways of rating companies on the basis of corporate governance practices. However, Sebi has not made it mandatory for any company to get the rating done keeping into the account the costs it requires. All this suggest that the considerable amount of initiatives have been taken in the country to improve.

Need of the hour

Corporate Governance is the need of the hour for India Inc. Keeping in mind the increasing globalization, corporate India will face problems having access to capital in future if good corporate governance practices are not adopted. According to Murali, "Indian industrialists will no longer be able to depend on soft money from the public financial institutions such as IDBI as these institutions will be phased out slowly as they are most burdened with bad debts." Also accessing the international markets for capital will be a bottleneck for the companies having poor corporate governance practices. A very good example of this is California Public Employees' Retirement System (Calpers), which believes that good corporate governance leads to improved long-term performance and considers corporate governance

as an important criteria for investment decisions in other countries and as of now has excluded India from any investments being made due to inadequate corporate governance practices. Hence Murali says, "with increasing globalization, international competition, it is necessary for Indian corporations to adopt good corporate governance in order to tap global financial markets."

Other reasons that contribute to the spur in activities of corporate governance are increased global competition by way of reduction of import tariffs and quotas. One more factor is the financial press, which has, of late, increased the level of coverage and hence embracing corporate governance is inevitable even to survive in some cases. Also the environment of family led business in India, which was largely popular before 1990 has been replaced by a young breed of managers and entrepreneurs and this has contributed a lot to the growth of corporate governance in the country. Foreign institutional investors, who are in a position to influence the corporate governance practices as they control massive funds, have facilitated a positive shift towards corporate governance. According to Murali, "the increasing role of FIIs increase the need for transparency in the utilization of investment by managers."

The efforts to improve corporate governance and transparency are underway but we have a long way to go to reach global standards

Sebi's dilemma

A tough decision for Sebi is to decide whether to make ratings for corporate governance mandatory or not? There are two factors involved in this, one if made mandatory the companies will have to incur additional costs on the compliance which include financial cost and time of top management. Two, if made mandatory, it will be an addition to the list of compliances and the necessary drive required for the same may not develop. For example, even when rating is not mandatory, ITC was the first company to get itself rated on the basis of corporate governance by S&P and was talked about largely in the financial press. Infosys has volunteered to get its corporate governance rating done from one of the agencies in India. These companies set an example and necessary drive for excellence for the whole corporate India. On this issue the President of FICCI, R S Lodha in a conference on corporate governance mentioned, "The moot question for consideration is as to whether corporate governance should be mandatory or voluntary one. It needs to be appreciated that trade and industry are currently overburdened with a plethora of rules and regulations including the most lengthy and complicated Companies Act and Income Tax Act. A question may, therefore, arise as to the necessity and desirability of further regulations."

A Road Map of Corporate Governance Activities in 2002 in India

January	ICSI set Board meet norms
February	ICSI redefines directors' responsibilities
April	Sebi Chief stresses corporate governance ratings for companies
May	The Department of Company Affairs (DCA) started deliberations on developing a comprehensive framework to ensure and promote good corporate governance
July	Rating agencies invited to evaluate corporate governance
August	A Government Accounting Standards Advisory Board (GASAB) for the Union and States established by the Comptroller and Auditor General (C&AG) of India.
October	Two companies seek ICRA rating on governance
November	Corporate governance institute planned by DCA
	Narayana Murthy to head corporate governance panel
December	Rating of corporate governance practices not to be mandatory by Sebi.

Outlook

Although quite a lot has been done in India for corporate governance, there are lacunae and shortcomings in the Indian system: India has weak laws relating to bankruptcy, the accounting standards are considered inadequate, stock markets are inefficient, bond and pension market is at nascent stage, mutual funds couldn't do well. Considering all these factors, it is obvious to note that initiatives have to come equally from all the types of bodies in different industries.

Only a collective effort can improve the scenario and increase the level of corporate governance. As Murali opines, "It is still a long way to go in improving accounting practices in India compared to the US. It is absolutely imperative for Indian corporations to improve them if they want to compete in the global marketplace." The efforts to improve corporate governance and transparency are underway but we have a long way to go to reach global standards.

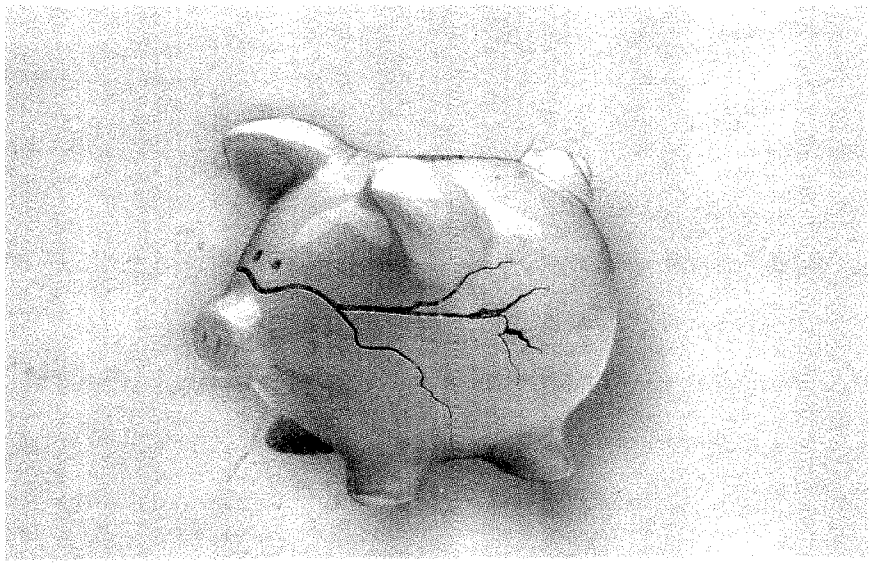
Abhishek Agrawal

Reference # 1-2003-01-11

MUTUAL FUNDS

The accountability issue

Redemption pressure by investors on fund managers, together with competitive pressure on performance (to which their pay is linked), makes fund managers to necessarily have a short-term outlook. This short-termism then gets passed on to corporate managers, who, because of the enormous size of mutual funds, do all sorts of shenanigans to meet the 'analyst expectations' says J Mulraj, Independent Columnist, *The Times of India*.



Investors can't be blamed for feeling that its all mutual fun and games in the fund management industry; studies have shown that a majority of US mutual funds underperform their S&P 500 index. And yet, paradoxically, the industry continues to receive funds for management, growing to a size where, at least in the US, it has, with $7 tn of assets, overtaken the banking industry.

Globally, money has become institutionalized, moving away from individual hands into institutional ones. To give an idea of the strength of this global pool of money, consider what the authors of a book *Market Unbound* say. The stock of liquid financial assets in the year 2000 was estimated to be three times the combined GDP of $27 tn, of the OECD countries! This huge pool of money, combined with the overzealous focus on creation of shareholder value, is a dangerous brew. Portents of which have manifested themselves in the scandalous revelations of events at Enron, Global Crossing, WorldCom and others.

What is happening is this. Most mutual funds are open-ended, with NAV-based redemptions. Redemption pressure by investors on fund managers, together with competitive pressure on performance (to which their pay is linked), makes fund managers to necessarily have a short-term outlook. This short-termism then gets passed on to corporate managers, who, because of the enormous size of mutual funds, do all sorts of shenanigans to meet the 'analyst expectations'. This is harmful to the companies and to their other stakeholders and, since it does not result in consistent performance by mutual funds, to their investors too.

Consider just one example, that of Lucent Technologies. After its initial listing in April 1996, as a spin off of AT&T (including the famous Bell Labs), it was the darling of the market, meeting analyst expectations quarter after quarter for 13 straight quarters (it supplied telecom equipment to the Baby Bells). Under the term of its CEO Richard McGinn, the company met Wall Street expectations until mid-1999 and its stock zoomed. An article in October 23, 2000 issue of *Red Herring* (http://www.redherring.com/companies/2000/1023/com-lucent102300.html) talks of how McGinn failed to see the shift toward fiber optics and thus, lost out market share and leadership to Nortel. The main reason for this blindness was the pressure to deliver quarterly numbers placed by the fund industry. McGinn lost his job in three years and the company had to lay-off half its employees.

What can be done? Here are a few suggestions for AMFI to get the industry to discuss

Explore ways to avoid dependency on NAV-based redemptions: Years ago, IDBI Mutual Fund had brought out a fund called I-Nit which was quasi-open-ended. It was a closed-ended

fund which opened an exit window twice a year, with parent IDBI (then in a healthier state) providing an assurance of buying at NAV related prices. The fund industry should hold discussion to see whether such an idea, or a variant thereof, could be explored. Without the short-term, NAV imposed redemption pressures, mutual fund managers would be able to invest for a longer term, something that can only benefit industry.

Revisit the fatal assumption: Fund managers operate under an assumption which I term as a fatal assumption (fatal, of course, to their investors). They assume that it is their investors who make the capital allocation decision, by deciding how much of their money to invest in equity funds, how much in debt funds and how much in other assets.

The job of an equity fund manager, therefore, is to invest in the best way possible the funds thus obtained. He does not consider it his job to pre-empt redemption pressures by selling when the market is over heated, even if he were to believe so! There ought to be some serious thinking on this assumption. Both the regulator, Sebi, as well as the trustees of the mutual funds, ought to both encourage and give more flexibility to fund managers to be a bit more proactive in management of funds, especially when they foresee a downswing. They could, if necessary, adopt hedging instruments that are now available.

The most famous investor of all times, Warren Buffett, had once returned all the funds in a partnership he was managing, on the grounds that he could not see any worthwhile investing opportunities. Investors depend on fund managers to get them out before a collapse; it is wrong to assume that investors are better equipped than fund managers to spot the coming downswing and seek redemption.

Why don't mutual funds meet investors at AGMs? If the funds under management by the fund industry are larger than most companies, why is it that fund managers and the AMC Board are not required to meet their constituents, just as corporate managers are, at least once a year, in an AGM? At least the larger funds could be requested to start this trend, most notably the UTI. Would this not bring a measure of desired accountability?

Can we ask them to put their money where their mouth is? Would it be a fair proposition to suggest that all senior managers of funds invest a part of their remuneration, in their own funds and with proper disclosures about exit? Would that not encourage them to be more proactive in management?

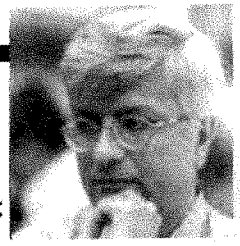
The consequences of having a short-term outlook spurred by pressure from mutual fund are horrendous

The consequences of having a short-term outlook spurred by pressure from mutual fund are horrendous. There are several examples, besides Lucent, of the consequences for other stakeholders. Tens of thousands of jobs have been lost.

The US has a far more flexible labor market besides having social security; the consequences for India would be far worse. The November 11, 2002 issue of *BusinessWeek* carries an article 'Siemens proves prudence is a virtue' which compares the fate of Siemens and ABB, both operating in the same industry. In the mid-1990s ABB was a darling of the markets because it did all that the market told it to. It made acquisitions, financed by debt, had a healthy top line growth, and went into sexy businesses. Its boss, Percy Barnevik, was hailed as the European equivalent of Jack Welch; alas he has left in a trail of controversy. The company is suffering from a huge debt burden and is losing money.

Siemens, meanwhile, has stuck to its knitting, unperturbed by pressure from analysts or fund managers, is now making decent returns on its capital and has far lower levels of debt.

The issues are serious enough to be considered. Somehow we should bring the 'd' back to fund management and let it then be fun for all.



"If the funds under management by the fund industry are larger than most companies, why is it that fund managers and the AMC Board are not required to meet their constituents, just as corporate managers are, at least once a year, in an AGM? Would this not bring a measure of desired accountability?"

J Mulraj
Independent Columnist
The Times of India

Reference # 1-2003-01-12

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EQUITY MARKETS

Issues and challenges

Conflicting views are emerging from various market players for buying into equities resulting in confusion, which has led to caution due to no consensus about the direction of market movement, says Dr. A S Harish, Senior Officer, The Vysya Bank Limited, Bangalore.

The stock market is fascinating, dynamic, complex subject mystifying the investors on a continuous basis and understanding it is still a complex proposition despite operating in a high-tech environment. The Federal Reserve Chairman, Alan Greenspan had warned of 'irrational exuberance' back in 1996 and by Q1 2000 the indices were much higher. It was impossible, according to him, for a Central Bank to know with sufficient certainty whether rising asset prices were unsustainable. But even if it were possible, he argued, higher interest rates would not necessarily burst the bubble and, if they did, they would only do so by inflicting damage to the broader economy. But then, in 2000 the technology euphoria ended and market crashed from its high levels. At a time, when the technology stocks are beset with too many question marks for any trend to emerge, a spate of bad news stuck the markets including terrorists attack on September 11, 2001, controversies regarding accounting imbroglio, surrounding companies like Enron, WorldCom, Arthur Andersen etc. The creative accounting in a way has also contributed to the stock market bubble; boosted stock prices that did not reflect underlying realities. The problem was compounded in many cases by valuation based on future revenues rather than on cash generation. The fallout was swift. As the old saying goes: Don't count your chickens before they hatch. It is evident that some companies not only counted their chickens, but also sold them in forward. The major fallout of the accounting issues is the increase in bankruptcies in the already beleaguered US corporate world. This has impacted the financials, of banks too, which would take big hits on their loan portfolio.

The downgrading of key financial stocks like Citigroup and JP Morgan has made investors jittery, cumulatively resulted in crisis of confidence about corporate earnings reports and credibility of CEOs. It is a sorry state of affairs to see fund managers and rating agencies (S&P and Moody's) having access to the research, resources etc., erring in a big way. The credit rating agencies S&P and Moody's had rated Enron as 'Investment Grade', a sign of strong creditworthiness a week before it defaulted. In the US, corporate accounting and its impact on investor confidence has reached alarming proportions. A serious damage too has been done to stock markets world over. The largest securities firms are currently trying to settle multiple investigations whether their stock analysts touted companies to investors in order to win their investment banking business.

Back home, the Indian stock price too has come down, driven by US markets in particular and domestic issues such as terrorists attack on Parliament, delays in divestment, S&P downgrade, Tata Finance and Ferguson episode etc.

There is an ample liquidity throughout the developed world and the Indian economy too. The current liquidity in the Indian banking system is being driven by strong forex inflows, strong growth in deposits and poor credit demand. The funds are finding its way into investment avenues in fixed income. The excess liquidity does not seem to be finding its way into stock markets even though the markets are arguably cheap on the most valuation metrics. The dilemma of excess liquidity at macro level, which does not find its

way into the stock market, can be attributed to different points of view for not buying equities.

The corporate sector focus now has shifted to strengthen the balance sheets, reducing leverage, improving cash flows resulting in not buying equities. The second category of investors i.e., households, who invests both directly and through mutual funds are currently active in debt funds besides pulling money out of equities. It is unreasonable to expect this category to buy equities in any significant way till the market starts moving upwards and regains confidence. On the other hand, conflicting views are emerging from various market players for buying into equities resulting into confusion, which has led to caution due to no consensus about the direction of market movement. In the past, it was UTI, which used to rescue the markets in times of crisis, but today that lifeline no longer exists with UTI being bailed out by the Government.

Regulatory measures

Since the takeover code of the Sebi came into existence in 1997, 53 companies have got de-listed from the exchanges since April 2000, of which 38 are MNCs according to Bombay Stock Exchange data. The predominance of MNCs in the list is also due to the liberalizing foreign direct investment norms since the early 1990s. Today with the exception of a very few strategic sectors, MNCs can set up 100% subsidiaries to increase the parent's stake in their existing subsidiaries, associates or affiliates by way of creeping acquisitions or an open offer, which is the preferred mode where public shareholding has fallen to less than 25%. Incidentally, the parents had set up these subsidiaries not in their eagerness to get a listing on the Indian stock exchanges, but to comply with the then prevalent rules.

However, entry and exit of a company in a liberalized environment is purely market-driven. But a moot question is: Is the process of de-listing transparent and pricing fair? Against this backdrop, Sebi appointed committee to prepare a *modus operandi* that would create a level playing field for investors. The report is already presented which includes a recommendation on reverse book building price to be considered for de-listing among other recommendations. The current pricing mechanism for de-listing only takes into account historical prices without looking into future business potential. Sebi has to devise an appropriate buyback formula, which should consider among other things, the future business potential and the exit premium.

The takeover code, though fairly explicit on what constitutes control, also contains a clause that leaves the issue essentially to the regulator's judgement. The takeover battles for instance in the past ended with the raider beating a retreat, usually because of government intervention through the FIs on behalf of existing management. FIs must be free to act in the best interests of their own shareholders. The regulator on its part must act impartially, independently and speedily so that, its integrity is not at any time compromised.

Sebi has to devise an appropriate buyback formula, which should consider among other things, the future business potential and the exit premium

The Stock Exchanges (SEs) with the exception of National Stock Exchange (NSE), are 'mutual' organizations—members elected representatives from amongst themselves to run the SE, and regulate their own activities. As a result, in spite of having surveillance systems in place, SEs did not take action against erring members. The Sebi board has approved the proposal for demutualization and corporatization of stock exchanges. However, it is immature to assume that merely by demutualizing and corporatizing SEs, i.e., by separating trading from ownership rights, the problem of conflict of interest will be addressed. Even after demutualization the present members of an SE would continue to have ownership rights in it, and thereby have a say in its functioning, and simultaneously trade on the SE. Therefore, it is essential to create a structure, like that of the NSE where three different sets of people—FIs, the Board of Directors and Traders—own, manage and use the services of the SE. This would require that an existing member give up either trading or ownership rights. A better option would be to curb ownership rights, through restrictions on voting rights, of those members who want to retain ownership as well as trading rights on a demutualized SE. In such a situation, public representatives and other owners would ensure that trading members do not take control of the SE for their benefit. The other issue that needs consideration is the regulation of demutualized SEs. Sebi has to decide carefully on the regulatory role of the SEs and should not nominate its members on the boards of SEs as this makes the regulator a party to all decisions. In the event of things going wrong, this compromises Sebi's position.

It is time the market regulator realizes and recognizes the role of auditors especially in the aftermath of the AF Ferguson episode. Sebi has already announced its intention of reviewing every piece of capital markets regulation that has been enacted in the last decade of its existence and has been setting up committees on every conceivable issue. It is surprising that Sebi has

ɔt set up a committee to ɔcommend measures to supervise ıditors, which the US Congress ɔcently authorized the Securities ıd Exchange Commission.

ontemporary issues

here is a shift from efficient arket hypothesis, which says that rice reflects fundamental value, efined as the best possible forecast, iven available information, of a ecurity's future cash flows, iscounted at a rate that is ppropriate for the risk of those ısh flows to behavioral finance. he proponents of behavioral nance argue that investors can ıake systematic errors in ɔrecasting cash flows or in setting ıe discount rate and these errors ffect stock price away from ındamental value for extended eriod of time. The stratospheric se in the value of US equities and f the technology sector in articular during the late 1990s has haken many observers' belief in fficient markets, and drawn many ɔ the behavioral finance view. This aises the possibility that ehavioral finance may replace the fficient markets hypothesis as the ominant model. The empirical esearch is underway on nderstanding and testing the roader predictions of the two ıodels.

The weakening of the US conomy, corporate accounting candals etc., have resulted in ollar depreciating against some urrencies particularly the Indian upee. The rupee has appreciated gainst US dollar in the last six ıonths in view of excess dollar upplies particularly export arnings of technology companies nd comfortable forex reserves osition. And given that the RBI's ollar buying has limits—while the un up in reserve is great, the flip ide is an equivalent expansion of upee liquidity, which has already oftened interest rates and it is xpected by some market players hat rupee may strengthen beyond 48 to dollar by the year-end. There is a need for change in mindset, as we are always accustomed to think of rupee depreciation. We have already seen this happening in the case of interest rates, wherein in the past the rates were only expected to go up. But today we are seeing a different picture. The rupee appreciation would have an impact on the corporate fundamentals, which would influence the stock prices either way. The depreciation in the past and appreciation today would have a moderate impact on the corporate fundamentals. The sustainability or further softening of interest rates depends to a large extent on the creditworthiness of the Government. For instance, Moody's continue to maintain negative outlook on India's domestic currency rating due to high fiscal deficit even as it indicated that the country's foreign exchange rating would be revised upwards.

Investor's expectations are unrealistically high and have not gone down with the changing realities such as softening of inflation, excess capacity in the industry

Investor's expectations are unrealistically high and have not gone down with the changing realities such as softening of inflation, interest rates, excess capacity in the industry, reduction of import duty etc. A return of around 15% per annum considering the risk-return trade-off is a more realistic figure to expect from the market. The risk-free rate say the government bond has fallen by about 500 basis points over the last 2 to 3 years. Expectations from the stock market returns should fall accordingly, provided the risk premium is unchanged. Due to the various accounting scandals, and a corporate with the so-called strong financials, becoming Junk anytime, has resulted in high-risk perception of equities. Goldman Sachs research report recently used a simple approach to estimate market returns. The report used the axiom that equity returns are simply the sum of earnings growth rate plus the dividend yield. It used a critical assumption: Earnings growth tends to equal GDP growth on an average. It may be less or more for certain periods, but it tends to average out to the GDP growth number.

The Economic Times checked the applicability of the hypothesis to India. It has taken a sample of 348 companies for a period of eight years. It is found that the net profit growth rate is not substantially different than growth rate of nominal GDP. Current expectations of nominal GDP growth over the next 2-4 years are about 10 to 12%, with real growth of about 6 to 7% and inflation of 4 to 5%. The dividend yield of sample companies is about 3.5%, having increased from a less than 2%, 5-6 years ago. Adding this to the expected earnings growth, the expected stock market return then should be between 13.5 to 15.5%. Hence, there is need for a shift in the investor's mental programming of high return on equity investments.

The Chairman of Reliance Industries Limited Dhirubhai Ambani has departed for his heavenly abode. He made Reliance Industries becoming India's largest private sector company, with gross turnover of Rs. 57,120 cr and net profit of Rs. 3,243 cr with a net worth of Rs. 27,812 cr and a market capitalization of nearly Rs. 42,000 cr in the year ended March 31, 2002. An investor with 100 shares in Reliance's initial public offering in 1977 would have seen his investment of Rs. 1000 appreciate to nearly Rs. 1,54,000 by March 31, 2002—a phenomenal return of 22% per year, compounded annually, over a period of 25 years. On the other side of the spectrum, in the case of Tata

Group, Ratan Tata has still not got a successor in place once he calls it a day.

Executive compensation has been an issue. For instance, Infosys Chairman N R Narayana Murthy recently said that the CEO's salary should not be more than 15 times than that of the lowest worker. However, this is to be viewed against its positive impact on the bottom line and would make a huge difference, if the CEO owns substantial stake in the company, he would be compensated otherwise.

Till some time back stock options was the hottest and most preferred way of compensating top management and employees. With the bursting of the technology bubble, however, stock options have not only lost their charm but also their value. Currently, as in the US, and also in India except in the case of a few listed companies, stock options are not reflected in the financial statements. This information is only found in the Notes on Account' section of the financial statements. Warren Buffett, has said when a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if expenses don't belong in the earnings statement, where in the world do they belong? Coca-Cola Co., for instance, will get quotes from brokerage firms to buy or sell options with the same characteristics as those granted to employees. Coke won't use an option-pricing model such as Black-Scholes formula.

The Alliance Capital Management, a firm known for its street savvy fund management, is reported to be evaluating its businesses in key emerging markets including India. Pioneer MTI, JP Morgan and Newton Investment Management have pulled out, while Zurich is holding talks with prospective buyers.

The Fast Moving Consumer Goods (FMCG) industry seems to have slowed down in its tracks. In the 1990s the industry witnessed an unprecedented boom due to liberalization, urbanization, increase in disposable incomes and altered lifestyles. The boom was also fueled by other factors like onslaught of satellite television and reduction in excise duties. The euphoria, however, started fizzling by the end of 2000. Another problem facing the FMCG is down trading by consumers. Premium brands are losing out to the mass-market brands as consumers are showing preference for 'value for money' products. Over the last 3 to 4 years, the stock prices of companies particularly engaged in FMCG has come down. In the past, the stocks of multinational FMCG companies were considered as a safe bet with moderate returns. The downward movement in the stock prices of companies such as HLL, Colgate, GlaxoSmithkline Consumer, Gillette etc., during the last 3 to 4 years, has resulted in revisiting the concept of long-term investing in multinational FMCG companies. In the Indian context, long-term need not always be equated with what is considered to be long-term in mature markets. Investors required to be extremely alert in monitoring their investments.

In the Indian context, long-term need not always be equated with long-term in mature markets. Investors should be extremely alert in monitoring their investments

Contrarian view

The personal intuition still works in sensing patterns of behavior, as there is always something unknown and indiscernible in the price. It is always people who make decisions based on their own abilities, emotions and financial resources. But people do not make decisions in isolation; they are influenced by friends, colleagues, news and inside information. In the end, it proved over a period of time that most individuals become part of the crowd and hence, not all of them make money. The winning requires the ability to recognize what the crowd is doing, move away from herd mentality and to do just the opposite. The contrarian view of course may not always work, as in the case of fixed income investments, those investors, who have taken the view that the interest rates may harden during the last one year, have lost in the game.

Now it is observed that people are taking too much of a comfort in fixed income investments and it is high time that people has to increase their allocation towards equities, taking a contrarian stand. It is generally observed that tend to lose is lower in a bear market scenario. Today we observe markets discounting good news quite reluctantly and too much of an aversion to equity, which is unwarranted. The Alliance founded in 1962, has long championed its own brand of growth investing buying stocks of companies with market values of at least $5 bn that have produced earnings growth rates of 12-15%. Alliance followed its Enron investments with a series of bad bets on other headline making companies for accounting frauds has followed V-method of making big contrarian bets. The Dean of Alliance's growth school, Harrison, developed its chief investing strategy, i.e., 'V-factor methodology'. Under this methodology, the fund aggressively buys stocks as they slip in price—the left side of the V—and sell as they rise—the right side. Well, it makes sense to stop loss or it may be time to sell and V-approach strategy of investing has resulted doing wrong on the stock for not selling on its way down.

uturistic perspective

o re-ignite recovery in the US, ederal Reserve has already lashed the federal funds rate that anks charge each other for vernight loans to 1.25% and the iscount rate Fed charges for mergency loans to banks to 0.75%, ıe first rate cut this year after 11 eductions in 2001. Today 'AAA' orporates are raising funds at a ate very close to government ecurities yield. Considering the nflation rate of around 3%, best orrowers can raise five-year ıoney at a real interest rate of 4% ; competitive internationally. Real nterest rates are now low enough o justify an investment spree, at east by the top corporates.

One of the issues gaining ırominence in recent days is a enewed focus on dividends and heir importance in investment lecisions. In the recent past, lividend was not a relevant nvestment criterion, as it ıccounted for a very small ıroportion of the total market eturn in the decade of the 1990s about 15 to 20%) in the US and nost growth companies refused to ıay dividends arguing that buying ıack stock was a more efficient use ıf cash or to conserve cash for uture growth. In fact, in the decade ıf the 1990s if a stock were to start ıaying dividends, the market would end to interpret it as a sign that the company had gone ex-growth and compress its multiple accordingly. Today many Wall Street strategists are trying to emphasize the importance of dividends. Their importance gets even more magnified in a very low nominal GDP and earnings growth environment like we have today, where capital gains are very difficult to come by.

Some studies too have shown that over time companies with growing dividends clearly outperform their peers that don't pay a dividend. There is also relationship between dividends and

Market Snapshot		
	Sensex	Nifty
Current	3352	1084
(December 20, 2002)	3269.31	1058.65
52-Wk High	3758.27 (March 4, 2002)	1205.95 (February 27, 2002)
52-Wk Low	2828.48 (October 28, 2002)	920.10 (October 28, 2002)
3-Year-High	6150.69 (February 14, 2000)	1818.15 (February 23, 2000)
3-Year-Low	2594.87 (September 21, 2001)	849.95 (September 21, 2001)

Source: The Economic Times

corporate governance. It is better for corporates to pay out their excess cash flows as dividends/ buybacks instead of retaining these surpluses and look for growth avenues to deploy them. As more often than not the misallocation of these surpluses lead to shareholders value destruction. The market is coming to the view that by and large, corporate management at this juncture with excess capacity and softening of prices may find it difficult to profitably deploy large chunks of capital and hence should be paid to the shareholders in the form of dividends. It would also discourage companies from inflating their earnings statements. They would only be increasing the pressure to pay higher dividends they couldn't afford. Stockholders would decide whether to reinvest their dividends in the same company or to invest them elsewhere.

Back to dividends would also result in companies no longer be tempted to load up with debt to increase earnings, taking advantage of the tax deductibility of interest payments. In addition, the stock option schemes could be curbed since returns on stock investments would be based more on dividends than on hopes for capital gains. The market currently is encouraging institutional investors to pressure companies to increase their dividend payouts to avoid situations like Microsoft with $40 bn on its balance sheet and Cisco with $21 bn as a means to discipline companies. The arguments for dividends versus a stock buyback are also being strengthened by the move in the US to abolish the double taxation of dividends, which is currently gathering momentum in the US Congress.

In such a scenario, companies that increase their dividends consistently would become the market favorites. The high dividend payout may enthuse the investors and start appreciating capital discipline and stops questioning the earnings outlook. The high dividend yield stocks can also give smarter capital gains when the market revives. The investors, however, need to consider the current working of the companies to ensure that companies maintain dividend percentage and maintain payouts in the changing business environment. It is also important to look at the past dividend payout ratio, liquidity of the stocks, track record of the management and the sector in which the company operates. The dividend yield makes much sense in the present softening interest rate scenario.

In the Indian context, there have been no fewer than three bull runs in the last decade, none of which had lasting effect and two of which were subsequently exposed as major scams. The average investor burnt his fingers badly in each of these boom bust cycles. Regarding the FII flow some $15 bn has come in during the past decade and the current value of investment is down by more than half. So the professionals have done no better than the ordinary or average investors. Among the 22 Indian companies that have a market capitalization of over a billion

dollars, there are just two manufacturing firms and one of them is in the public sector. Again great many firms that would command good value on the markets are privately held, including the ones like General Electric, Maruti Udyog, Coca-Cola, Samsung, and LG etc. *The Economic Times* world market survey revealed that India ranks 25th in terms of market capitalization, second in terms of number of companies, but a poor 85th in terms of average company size. In terms of average company size, US which is at the 2nd position, has an average size of $2173 mn, but India is way behind, at 85th position, with an average company size of just $19 mn. There should be more companies with strong businesses listed on the stock exchanges. It is observed that currently banks have huge liquidity and major portion of it either would be invested in government or approved securities like IDBI, IFCI etc. Government paper is no better considering the risk profile vis-à-vis stocks of some reputed companies in the market.

US Federal Reserve Chairman Alan Greenspan said that their ability to forecast is limited. It is possible to make reasoned assumptions. But we cannot know for sure because we are dealing with great uncertainty. The BSE Sensex today stands at a level almost what it was 10 years ago. Time and again the market has rallied but failed to sustain the momentum. Those investors who have done well in the market basically because of their stock picking strategy than investing in the overall market or market indices. Investor's confidence in corporate governance, equity research and the whole equity environment has been seriously damaged and thus, flows will be slow to come back. To attract equity investments, markets will probably have to decline to levels where valuation becomes compelling by any metric or enough time has passed to enable the wounds of the current market debacle to heal. Is there a fundamental trigger to ignite the change in the overall poor market sentiment? The Government's mid-term economic review has highlighted the good performance of the economy despite drought conditions and global slowdown. Industrial production is rising, exports have done well, interest rates are at record lows, inflation levels have come down, forex reserves are at record levels and the latest corporate results have been good.

Moreover, the improvement in the overall market sentiment is more a reflection of the movement in the global equity markets and increase in FIIs inflow to emerging markets including India for diversification of global equity portfolio. 'Who Dares, Wins'— It is observed over a period of time that the crisis in stock markets often produces opportunities for attractive returns over a period of six months to one year. With General Elections fast approaching, it is doubtful whether privatization would be a big theme during the next year or so. The improving economic fundamentals, Moody's possible upgrade of India's credit ratings, better than the expected financials of software majors, beaten down valuations, Morgan Stanley Capital International (MSCI) decision to marginally raise India's weightage in the Emerging Market Index and Microsoft Chief Bill Gates' visit to India provided the momentum to improve the market sentiment. It is observed that investors are increasingly warming up to the idea of getting back into the equity markets. The potential investment opportunities in corporations should characterize by a strong management team and unique or sustainable business model with a focus on bottom up approach to stock investing besides expertise in stock picking.

In the coming days, there would be increasing focus on disclosures, stronger boards and executive compensation

The process of creating and maximizing value entails a continuous search for corporate and business level strategies. Though growth, earnings, cash flow etc., are crucial but they are only the means to the end of maximizing the wealth of shareholders. The primary virtues always were Ethics and Integrity. The other issues such as competence, effective execution though important are just peripherals. The organization interest should not be subordinated to satisfy individual interest. Ethics and integrity should not be at any cost taken for granted.

If there's a lesson to be learnt from corporate America's recent experiences, it's no matter what management systems a company uses, if people behave fraudulently, nothing can protect it except the potential threat of loss of reputation and shareholder value destruction. The big business and capitalism currently are under scrutiny. In the coming days, there would be increasing focus on disclosures, stronger boards and executive compensation. The investment banking and accountancy would go through real reforms. The implications for markets from recent accounting scandals have been a definite premium for clean managements, finer scrutiny of company accounts by investors and general dislike for companies with possibilities of any hidden surprises.

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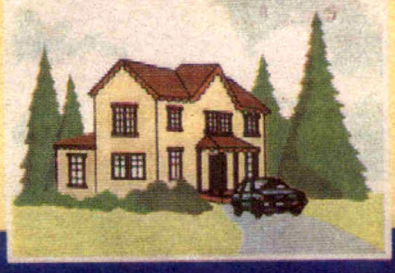

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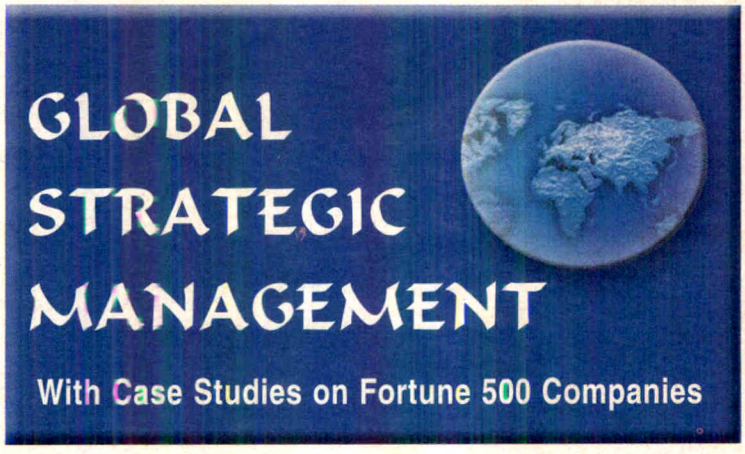

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Can India Achieve 8% Growth

The debate over whether India can achieve a growth rate of 8% has been going on for quite some time. Certainly, at a time when the global economy is caught amidst a recessionary trend, Indian economy has cruised along. However, of late, economists, industrialists, and policymakers are busy discussing how to put the country on a much higher growth track. Well, that might be easier said than done. One of the most significant hurdles the Government is facing today is on the fiscal deficit front. In order to meet the 8% GDP growth target, the Planning Commission has projected the Central fiscal deficit at around 4.6% and revenue deficit at less than 3% during the Plan period. However, in the wake of the fact that the fiscal deficit for 2002-03 is estimated to be in the range of 5.6-6.0%, such high deficit ratios obviously result in increased borrowings and reduce flexibility in budget making. And, bringing this level down to the projected levels is a mammoth task. This apart, the postponement of disinvestments in public sector units has jeopardized the prospects of mopping up the revenues. The fact is that during the period 1991-2002 only about 46% of disinvestments targets actually materialized. Another viewpoint is that the key to 8% growth rate would be to step up rural demand that would, in turn, generate higher demand for industry. The high production levels also have to be matched with a healthy balance of payment situation and higher foreign direct investments. All this would be possible only if the fiscal deficit of the union Government is contained within 4%.

Policymakers can also look forward to China for gaining some useful insights into how its GDP has grown at a rate of 8%. There are some major differences between the growth process of China and India. The Chinese growth rate has been mainly because of the growth in the manufacturing sector. While China's manufacturing accounts for 30% of GDP, the same in India is a mere 16% of GDP. Also, though China attracted far more foreign investment than India, the growth process in China was driven by productivity and not investment alone. The Chinese Government has successfully brought about major improvements in their productivity and has relied totally on the domestic economy to propel the growth rather than depending on exports. Some of the steps assumed by China to improve their productivity levels were changes in labor laws, reduction in import duties, elimination of small-scale industry incentives.

India can draw lessons from China and bring about similar revival in our manufacturing process as well. This would help to revive the economy as a whole and help the country to reach a high-growth trajectory. To debate on the issue, *Analyst* invited the following professionals: Pitabas Mohanty, Professor of Finance, XLRI, Jamshedpur; Saby Ganguly, Founder, www.indiaonestop.com, Kolkata; Dr. Sudipa Majumdar, Proprietor, Newel Consultants, New Delhi; Susmita Dasgupta, Economic Research Unit, Joint Plant Committee, Ministry of Steel, Govt. of India.

Pitabas Mohanty
Professor of Finance
XLRI, Jamshedpur

India has the potential to achieve a growth rate that is even higher than 8%. In India, even if the finance minister does nothing, the GDP can easily grow at about 4 to 5% per annum. Therefore, with sound policy initiatives from the regulatory authorities, India can easily achieve about 8% growth rate.

The six core sectors namely coal, steel, cement, electricity, crude oil and petroleum refining have reported about 6% growth rate last year. This growth was achieved largely because of an excellent growth in cement and petroleum refinery sectors. On the top of that if the services sector and the agricultural sector do well in this fiscal year, then it will not be very difficult to achieve a 8% growth rate.

Services sector: This is one sector that India can count on to help it achieve a very high growth rate. In the last year the performance of the finance and insurance sector remained very high. In the next year, IT sector can also be expected to contribute substantially to our overall growth rate. Of course this depends on how quickly the US recovers from recession.

If the services sector and the agricultural sector do well in this fiscal year, then it will not be very difficult to achieve a 8% growth rate

Agricultural sector: If substantial investments in the agricultural sector take place both by the government and the private sector, then this is one sector that will help us achieve a very high growth rate. It is unlikely to expect the manufacturing sector to contribute to the overall growth rate in a big way this year even if the general outlook seems very encouraging. This is so because there is a lag between the overall improvements in general outlook and the actual growth rate in the manufacturing sector.

As far as the current year is concerned, the major stumbling block seems to be the general downturn in the economy. However, there are certain other factors that can arrest the economic growth of our country and are mentioned here.

The major stumbling blocks to India's growth are the following:

- Politicization of the planning process
- Overdependence on monsoon by the agricultural sector
- Lack of effective action from the states

Major policy initiatives

Increase in consumer spending: The consumer spending in the last seven quarters has been less because of two reasons. The poor performance of the agricultural sector in the last year, and the recession in the economy are the two factors that have resulted in a reduced purchasing power by the consumer. Since lackluster demand is one reason why the overall growth rate is less than expected, this is also another factor that will determine the overall growth rate for the coming year.

More improvement in infrastructure in agriculture: Even if we get a good monsoon, this may not result in a substantial improvement in the agricultural output. Investment in the agricultural sector in the form of irrigation facilities, rural electrification etc., must take place to boost productivity in the agricultural sector. Since we have a surplus of food grains in India, the same must be innovatively used to build infrastructure in the agricultural sector. This will also increase the spending ability of the rural consumers.

Action from the States: In order to ensure that the objectives of the second generation reforms are met, namely improvement of the administrative, legal, and regulatory functions of the state, addressing the incentives and actions that are required to have private sector development and to develop institutional capacity for reforms, it is imperative that the states play an active role in the economic development of the country. Excepting a few states like Karnataka, Andhra Pradesh, etc., most of the states in India have not done anything significant to achieve the above objectives.

Depoliticization of economics: Another factor that will surely help us in achieving a very good growth rate is depoliticization of economics. As is evident from our recent experience with divestment of Nalco, and the two oil majors, unless the politicians take an objective stance on the economic issues, not much can be expected from our planning process.

As things stand now, coalition governments are going to be the order of the day. Therefore, if India has to achieve a 8% growth rate, then the center must have the guts to go ahead with such bold plans.

However, achievement of the last factor seems to be difficult in a coalition government because in a coalition government, the objectives of the different partners are different and that creates a conflict of interest between the different parties that have come together to form the government.

Since the second generation reforms also aim to help the poor, the impact of achieving the above

n the poor will not be adverse in ature. Here we must differentiate etween first and second generation eforms. While the poor people pay price (relatively) in the first eneration reforms stage, they tand to gain a lot in the second hase.

The success of Chinese reform is ue to policies that have created an ffective constituency for reform ithin the party and the state ector by pursuing a largely Pareto-nproving policy, in which no one is ade worse off. This basically nsured that the economic reforms ave the backing of the political eaders and the growth process does ot get vitiated due to bureaucratic nefficiency. I think this is the iggest lesson that India must learn rom the Chinese experience. This ill reduce the political and ureaucratic apathy to the growth rocess.

aby Ganguly

ounder
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ince I am not a hard-core economist, ıy view should be taken as that of n ordinary though somewhat ıformed citizen. I have ıyself done no research ıto this subject lately, ence I have to go by hat I 'feel' rather than hat I 'think'.

During my younger ays, a 3.5% growth ate—which many erisively called the Hindu growth rate'—as normal, and even onsidered good in the ontext of the realities f the time. Today, we consider .5% not good enough! So, just as our erformance has improved, so have ur expectations. If we have been ble to come up from 3.5 to 5.5%, we an as well go from 5.5 to 8%.

I am told our economic ndicators have been very encouraging in the current fiscal so far. The newspapers say that the index of six infrastructure industries registered a 6% growth in the first half, year-on-year GDP growth was 6% in the first quarter, exports have grown by 13.5% during April-September, forex reserves are at a record high of over $65 bn and inflation remains less than 4%. All this sounds very positive, and persuades me to believe that an 8% GDP growth rate each year in the next five years is realistic. This is assuming that no unforeseen obstacles come up: The obstacles could be in the form of bad monsoons, hefty oil price rises, and bad governance within the country.

The three biggest stumbling blocks are: Corruption, poor infrastructure, and bad governance. Corruption is so deep-rooted in our society that it cannot be removed by any method other than harsh punishment which anyway is not possible unless our Constitution is amended. And who will bell the cat? The politicians? They themselves are tainted with charges of corruption. Look what they did to tehelka.com after the website exposed alleged corruption at the highest political levels. The police? The less said about their level of honesty and integrity, the better. Of course, there are many honest politicians and policemen, but they are cases of individual exceptions.

The obstacles could be in the form of bad monsoons, hefty oil price rises, and bad governance within the country

Infrastructure problems are easier to tackle than corruption. Though our infrastructure remains far from world-class, there have been substantial improvements in recent years, and they are continuing. But infrastructure cannot be radically better in the next five years: Infrastructure development takes a long time and huge funds. But it is good that the awareness of the importance of infrastructure has caught on in our policy-making levels.

Governance is also a matter of concern. The fiscal performance of our states is dismal. I have read that the outstanding debt of all the states together more than doubled from Rs. 243,000 cr in March 1997 to about Rs. 500,000 cr in March 2001. This is potentially disastrous.

I have also read that the interest liability of all the states increased more than sixfold during the last decade from less than Rs. 9,000 cr to Rs. 54,000 cr. The combined salary bill of all the states has crossed Rs. 100,000 cr in 1999-2000 which worked out to over 5% of the GDP. With the pay commission havoc and mounting pension bills, we see an alarming deterioration in the states' finances today. All these are due to bad governance in the states.

There are potential obstacles which are not in our control. Ours being an agrarian economy, we have to depend on monsoon. We are talking about the five-year period of the Tenth Plan, and we do not know how the next five monsoons will be.

Foreign Direct Investment (FDI) is another uncertain area. The 10th Five Year Plan envisages an FDI of $7.5 bn per year, whereas we have averaged something around $3 bn to $3.5 bn in the past. How we shall make a quantum jump in this respect, is not known. We have to remember that India's attractiveness as a FDI destination today is not at the same level as it was in the early years of economic liberalization.

The number of enquiries about Indian markets currently received by IndiaOneStop.Com, which is one of India's earliest established global business-to-business portals, is far less than in the late 1990s. The Enron imbroglio, much before Enron itself collapsed, did no good to our image as a reliable partner

for foreign investment even in such a vital sector as energy.

However, if we show improvement on the three important fronts of corruption, infrastructure and governance, the FDI aspect will be favorably influenced.

In times of war and other national emergencies, the different political parties should decide that they would not make political issues out of such national causes. If this thinking is applied to the economy, then it won't really matter whether we have a coalition government or a single-party government.

The common man will be the immediate beneficiary of a crackdown on corruption, better infrastructure and good governance. However, efforts to make India more attractive to foreign direct investors or etc., may cause some hardship to the less privileged sections of the community. The government will have to be bold to speed up liberalization. But there is nothing stopping it from eradicating corruption and ensuring good governance.

Decisiveness. Decide on a policy, and go ahead and implement it. Don't dither. Don't try to please everybody. China's success story has firm decisiveness as its bedrock. But, the root question is: Can a parliamentary democracy such as India do what a totalitarian regime like China's could? I, for one, wouldn't mind seeing 15 years of totalitarianism in India for the eventual benefit of ordinary people.

More important than statistics, we have to worry about our miserable social realities. Illiteracy, child labor (even in cities like Mumbai and Kolkata, not to speak of villages in Bihar), lack of social justice and social security—the entire gamut of such aspects of life—are what we should have already alleviated in the past 55 years of independence. Today, we are like a family with severe internal problems being required to measure up to better managed and more harmonious families. We had a lot of time to alleviate our internal constraints, but we wasted that time in socialist rhetoric. Talk about 8% GDP growth is fine, but these things don't take into account our social realities. Ultimately, the economy is for society, not society for the economy.

Dr. Sudipa Majumdar

Proprietor

Newel Consultants, New Delhi

The Annual Budget for 2002-03 has embarked on the ambitious Tenth Plan that seeks to achieve 8% GDP growth rate. The Government has chalked out a plan of enhanced implementation of policies, speedier economic reforms, employment-oriented growth and re-targeting of subsidies and all these are aimed at accelerating the GDP growth to 8% and beyond. However, one cannot help commenting that after more than a decade of reforms and despite all efforts, our GDP growth rate is still hovering around 5-5.5%.

The common man will be the immediate beneficiary of a crackdown on corruption, better infrastructure and good governance

A growth rate of 8% would require industry to grow by at least 12%, along with an agricultural growth of at least 4%. The key to 8% growth rate would be to step up rural demand that would, in turn, generate higher demand for industry. The high production levels also have to be matched with a healthy balance of payments situation and higher foreign direct investments. All this would be possible only if the fiscal deficit of the Center is contained within 4%. This scenario looks extremely far-fetched and, consequently, even 8% GDP growth seems unrealistic.

Some of the basic requirements would include a serious focus on increasing investments in agriculture, rural development, infrastructure including power and road, education, health, family welfare, science and technology and tourism. But, these are some basic requirements on the resource side.

The most important stumbling block for the Government today is its fiscal deficit. In order to meet the 8% GDP growth target, the Planning Commission has projected the Central fiscal deficit at around 4.6% and revenue deficit at less than 3% during the Plan period. Drawing up a comparison, the fiscal deficit during 2001-02 was at 5.8% and revenue deficit was at 4%. The fiscal deficit for 2002-03 is estimated to be in the range of 5.6-6.0%. Such high deficit ratios obviously result in increased borrowings and reduce flexibility in budget making. Bringing this level down to the projected levels is a mammoth task, and seems quite improbable. The postponement of disinvestments in public sector units has jeopardized the prospects of mopping up the revenues. During April 1991 to March 2002 only about 46% of disinvestment targets actually fructified.

Another hindrance is the export levels of the country. The Government has drawn up a target of 12% export growth rates for the next five years. However, according to the Planning Commission, this would not be enough since the 8% GDP growth rate would require an export growth of about 15%, in order to maintain the current account balance and also generate sufficient demand. But, the medium-term strategy and targets of the external sector falls far short

f the requirements. In this ontext, the commerce ministry has een entering into strategic free ade agreements with countries ke South Africa, Brazil, Columbia, gypt etc., but one fails to nderstand why India has not been mphasizing on improving trade elations with its immediate eighbors.

We also have to keep in mind he fact that resources alone cannot ead us to a high growth rate. What s more important is improvement n efficiency and in resource tilization. The Government has een continuously drawing up olicies and programs, but there is a otal lack of proper implementation f the same.

There has to be extra effort on mproving implementation at all evels, along with strengthening of egulatory procedures like pprovals, appraisals, evaluations tc. Unless the machinery and rocess are in place, policies and argets would only remain on aper.

In 1990, India and China had lmost the same rates of GDP rowth. But today the scenario has hanged totally. India is still trying o make a success of its eform process while hina has grown much ister and has already eached a 8% GDP rowth rate.

There are some najor differences etween the growth rocess of China and ndia. The Chinese rowth rate has been nainly because of the rowth in the nanufacturing sector. While China's manufacturing ccounts for 30% of GDP, the same n India is a mere 16% of GDP.

Although China attracted far nore foreign investment than ndia, the growth process in China was driven by productivity and not investment alone. The Chinese Government has successfully brought about major improvements in their productivity and has relied totally on the domestic economy to propel the growth rather than depending on exports. Some of the steps assumed by China to improve their productivity levels were changes in labor laws, reduction in import duties, elimination of small-scale industry incentives.

India can draw lessons from China and bring about similar revival in our manufacturing process as well. This would surely help to revive the economy as a whole and help the country to reach a high-growth trajectory. Improvements in the manufacturing sector would contribute in a far more significant manner to the overall output of the economy and also create more jobs in the sector.

Susmita Dasgupta

Economic Research Unit
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India is still trying to make a success of its reform process while China has grown much faster and has already reached a 8% GDP growth rate

The contradictions around the claim whether India can at all achieve an 8% growth rate assumes importance in the latest revision of the growth figures by the government. Government sources have now downgraded the Tenth Plan growth projections to about 5.5%. What is significant is that this downgrading takes place due to the large debts of the states on account of their Plan outlays and not due to the non-plan expenditure. This means that the country is unable to absorb funds towards development. This is a serious matter and it flies in the face of the usual contention that large non-Plan expenditures were burdening the finances of our country.

It was usually assumed that a large burden of bureaucracy and other kinds of non-Plan expenditures were inducing the Government to borrow money and thus raise the rate of interests in the economy.

However, investments did not take off despite a reduction in the rate of interests—both nominal and real. Then it was assumed that the Government was not spending enough on infrastructure. But now it is proved that even such expenditure has failed to yield economic growth.

It is not easy to identify the stumbling blocks in the path of economic growth. But by the process of elimination we can easily observe that such blocks do not exist either in the government policies or in the nature of government spending. The decelerators of growth lie in the nature of community ties and in the density of social capital. It is here that we could really compare the economic growth of China and of India.

In China, social ties are much more intense, the community can quickly galvanize itself into action and it can fall into relations of exchange very soon. Unfortunately in India, this is not possible because our society is more impersonal and less capable of concerted actions. This is only a tentative hypothesis and in no way should be treated as a final answer.

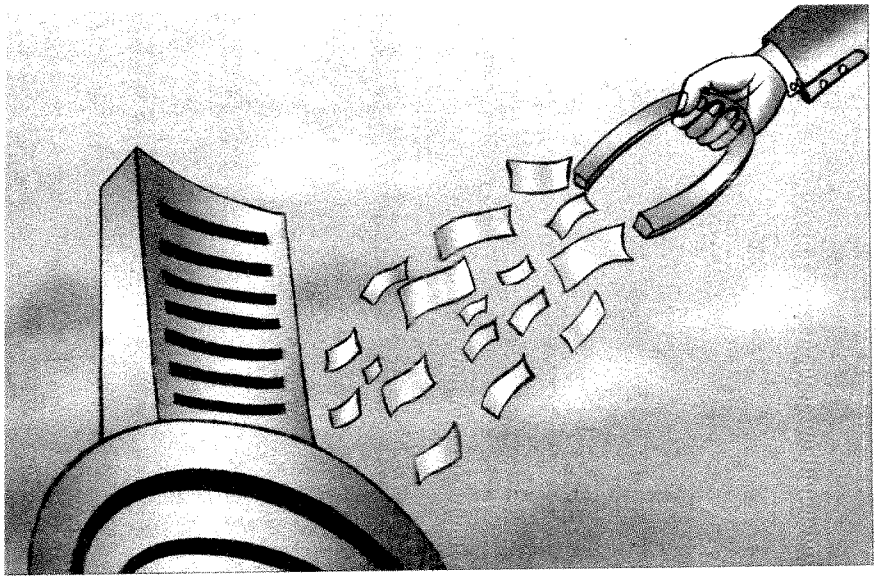
The views expressed are the personal views of the participants and not necessarily of the organizations they represent.

Reference # 1-2003-01-14

BUYBACKS

Increasing at a dizzying pace

In light of bearish stock market conditions, corporates worldwide are finding buybacks a good investment opportunity.



With the stock markets dipping, corporates worldwide are joining the bandwagon of buybacks. Many companies such as Merck, PepsiCo, Citigroup and Home Depot launched their buyback programs. The number of companies going for buybacks reached as much as 100 for the month of July 2002 alone. This implies a global buyback of more than $43 bn, a little less than the buyback programs following the attacks on WTC, which resulted in total buybacks worth $54 bn.

It is generally observed that during times of bad economic environment companies opt for share buybacks. In 1987, after the crisis and stock market crash, 777 of the publicly traded companies announced repurchase programs. This resulted in increasing the Dow Jones industrial average to the extent of 11.5%. Following the same pattern, the buybacks after September 11 attacks also helped in the minor recovery of stock exchanges. According to Rick Wayman, CFA, www.researchstock.com, "Management views its stock as undervalued and thus a good investment. I find this a weak reason for a buyback. If the stock is cheap it is usually because of a fundamental weakness. Funds would be better spent on correcting the fundamental problem instead of this cosmetic solution."

Buybacks math

Buybacks were firmly grounded by Henry Singleton, the long time Head of Teledyne, where he continuously repurchased the outstanding shares to the extent of 85% between 1972 and 1984 thereby increasing the shares' stock market value consistently. Singleton's ruse was to buyback the shares when they were cheap. The concept is still followed by several corporates world over.

Many analysts feel that the buybacks imply undervaluation of companies stocks. The companies plough back some of the outstanding shares thereby creating a shortage of shares in the market, which ultimately results in the revival of the scrip. Contrastingly some of the industry experts feel that companies go for announcing buybacks when they can't find anything better to do with their cash and hence there exists less or no scope for further expansion. *The Economist* reported that, "Warren Buffett, a famously canny investor, regarded well-timed buybacks as a clever way for managers to invest cheaply in a company they know (their own) rather than expensively (through a merger at a premium) in a company they don't."

Another objective of buyback of shares may be to manage capital structure. In many countries including India, the interest paid on debt is tax deductible unlike equity. Buybacks act as one step towards improving the debt-equity ratio of the company thereby reducing the total average cost of capital. All said and done, theoretically buybacks should make no difference to the shareholders, whether the company returns cash in the form of increased dividends or by way of repurchase. However, buybacks have an impact on the underlying forces on which investor behavior is based. For example, when a company raises its dividends, it has to keep raising it in future to keep up with the expectations of stockholders; however, buyback doesn't have any such implications. Adding another dimension, Wayman says, "It is a way to manage dilution that is caused by option

rograms. In this sense, a buyback is ood because it prevents dilution."

SOP saga

n the early 1990s, many companies epurchased their stocks to provide it employees in the form of stock ptions. The objective was to align ne employees' interest to the stock narket in order to motivate them to erform better operationally and inancially and improve the ompany's performance substantially. Iowever, this always backfired for he simple reason that the ompanies repurchased the shares at narket price and employees at a nuch lower price than that. This esulted in a loss making deal for the ompanies and also the basic bjective of spurring the share prices vas lost. In few of the cases, the mployees exercised so many ptions that the outstanding shares emained unchanged and urthermore, in few other cases, the umber of outstanding shares xceeded after the buyback thereby educing the company's EPS. Iowever, there is a common feeling mong the investors and the critics f buybacks that the company should ut its cash for some better use and ain organic growth in the share rices rather than trying to inflate it y artificial means.

European outlook

Many European countries do not avor buybacks. Government egulations prohibit buybacks or make them unattractive. For example, in Austria the logic for anning buybacks is simple: They feel that a company which spends money on buying back its shares is 'hollowing out' its capital base, when instead it should be using its capital to expand and invest in new job- and wealth-creating projects. Paradoxically, this has cut back the growth of many European countries. Wayman comments, "In this economic environment (US recession), I think the funds would be better saved for a 'rainy day'. Especially if the company has to incur debt to fund the buyback."

The companies which wanted to go for buybacks had to forcefully invest in some other ventures that did not suit them in the long run. *The Economist* says that allowing repurchase does not deter investment but recycles it. The individual investor gets a choice of investing in the upcoming sector thereby spurring growth in the economy.

Indian scenario

In the past two years as many as 30 MNCs delisted their stocks in India including Cadbury, Reckitt Benckiser, ITW Signode, Aventis CropScience, Carrier Aircon and Philips, which invited a close scrutiny by Sebi. The reasons for this is surely the same of leveraging the dip in the performance of stock markets and buying back the equity at lower prices.

Companies, however, may buyback the shares during stock market recession and come out with a fresh IPO with premium when the market revives in minimal time. To avoid such a situation and prevent the malpractice by using the tool of buyback some of the recommendations made by the Sebi Working Group constituted by Sebi earlier are as under:

- Any company that buybacks its shares will not be allowed to issue fresh capital, except bonus issue, for another 12 months if the shares are bought back and extinguished, and for another 24 months if the shares are held as Treasury Stocks. This will prevent manipulations of share prices through buyback.
- Promoters have to specify the amount to be used for buyback and get prior approval of shareholders.
- Only free reserves are allowed to be utilized for the purpose of buyback.

The objectives for any buyback are more or less similar in India as of that globally: To prevent hostile takeovers; to return surplus cash to shareholders by way of buyback; increase underlying share value during lean periods and; improve the debt-equity ratio.

> **"One of the objectives of a buyback program is to manage EPS. Buybacks are a way to reduce the float and thus boost EPS."**
>
> **Rick Wayman**
> *CFA, www.researchstock.com.*

According to a study conducted by San Diego State University Professors S G Badrinath and N Varaiyat for the Financial Executives Research Foundation, there were five basic reasons cited for repurchase: To boost stock price, to rationalize the company's capital structure, to substitute for cash dividends, to prevent dilution from stock option grants, and to give excess cash back to stockholders.

Buybacks mostly leverage the downward trends in the stock market. Considering this, the timing for the announcement of buyback is essentially critical. Of course, recent launches of open-market buyback programs like PepsiCo and Home Depot could get affected by market events as well.

Currently, there is a spree of global buybacks and it can be contributed to the bearish stock markets. According to Wayman, "This trend is probably trying to support the stock price by minimizing dilution (if there is an option program) and/or boosting EPS." Some of the CFOs believe that if the company is investing at a level required, buyback is the best way of returning value to the shareholders.

Abhishek Agrawal

Reference # 1-2003-01-15

P&G's TURNAROUND

Back to basics

In just two years and three months A G Lafley refocused the company onto its core brands, Tide, Crest, Vicks and Pampers, slowed down the pace of new product development, stabilized the organization culture and most importantly cut costs to bring the company back to profits.

This Cincinnati-based *Fortune* 100 company, a diversified consumer products giant having operations in over 70 countries and employing more than 110,000 people ran into trouble in the late 1990s when it neglected popular core products such as Ivory soap, Pampers nappies, Crest toothpaste and Tide laundry detergent. The problem was augmented when all efforts went into new product development and marketing while the culture changed dramatically in this traditionally managed 165-year-old company.

As the situation degenerated by early 2000, when the stock plummeted to around $55 from nearly $120 in a matter of months and the global consumer goods behemoth was gripped in profit warnings, the Procter & Gamble veteran A G Lafley was brought in abruptly to replace Durk Jager as chief executive in June that year.

In just two years and three months Lafley refocused the company onto its core brands such as Tide, Crest, Vicks and Pampers, slowed down the pace of new product development, stabilized the organization culture and most importantly cut costs to bring the company back to profits. As a result, the once beleaguered company's stock is now soaring; it has been delivering impressive earnings for eight straight quarters and is busy charting out future plans.

Refocusing on core brands

Way before its earnings warnings and stock slump, P&G had been struggling for years with the basic age-old problem associated with size—how to grow a $40 bn company? Well it would take $400 mn in additional sales just to grow by 1%. As a result, between 1990 and 2000, the company failed to meet its goal of doubling its sales every decade (something which it had done in every previous decade since 1940).

On top of this inherent problem, Lafley's predecessor, Durk Jager, pushed the company onto his aggressive plan of launching a slew of products in the hope of finding the next billion-dollar blockbuster like Tide or Pampers (the hugely successful diaper brand), thereby deviating required resource and attention from the current hits (Tide, Pampers, Folgers, Crest, Pantene.). The chase proved elusive as Olay Cosmetics and Fit, a fruit wash, flopped. Jager's effort to globalize P&G's brands, by selling its products under different names around the world, also flopped. In Germany, for instance, P&G changed the name of its popular dishwashing liquid from Fairy to Dawn (as per the new strategy) only to see its sales for the brand plummet because nobody in Germany knew what Dawn was.

Jager, an aggressive change agent with a confrontational management style disliked by many in the company, shook P&G's culture and pushed P&G to escalate development of new products. He even jeopardized P&G's identity by proposing to buy two large pharmaceutical companies (the purchases never happened though). In his endeavor to radically change P&G from top to bottom, he neglected the immediate goals of earnings growth. Jager's tenure was abruptly brought to an end after 17 volatile months. (In fact, his is the shortest CEO tenure in P&G's history). And Lafley was brought in to rescue the consumer products' giant. Since he took over as CEO in June 2000, he has refocused the company on its core brands and its biggest markets, including the US and Western Europe.

Relying on core

Lafley managed to do what none of his predecessors couldn't. He recognized that the need of the hour was to get the company back on its firm pillars of growth rather than trying to build new pillars. He decided that P&G would concentrate on four of its biggest businesses—laundry, baby care, hair care and feminine care—all of which had been losing market share. So, he deftly refocused the company on the big brands that drive earnings, including Pampers, Tide, and Crest. Like Jager, Lafley also resorted to acquisitions to grow, but unlike him he made sure that they are close to P&G's core strengths as evident from the purchases of Clairol and Spinbrush—an electric toothbrush—as against Jager's Iams pet food and PUR water-filter systems. Sydney Finkelstein, Steven Roth Professor of Management at Tuck School of Business at Dartmouth University in the US, describes Lafley's role in the turnaround thus, "Lafley has been a huge presence in getting P&G into shape. He has the vision, and

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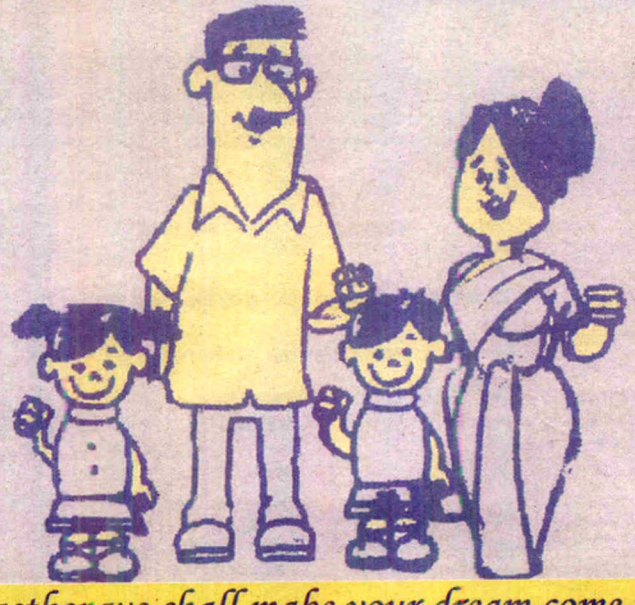

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ıe hands-on skills, and has roceeded at a quick, but not rushed ace (which was a problem with his redecessor)." Lafley is getting the ompany back to basics, which oesn't mean saying no to new roducts rather it is about striking a alance between old and new rands.

In order to find the balance etween sales and profit growth—omething that evaded his redecessor—Lafley did away vith slow-growth products such as risco and Comet. Instead he ought out faster-growing, more rofitable products in areas such s beauty and hair care. In ccordance with this strategy he ought Clairol Inc. for $4.95 bn ast November. And, to boost up he bottom line, deptly cut costs. Most importantly hough, unlike Jager, afley has been etting achievable goals. For example, afley scaled back P&G's long-term erformance goals to 4% to 6% sales growth, from the nrealistic 6% to 8% f Jagers'. He also imed for just 'double-digit' earnings growth instead of Jager's very specific 13 to 15%.

From the beginning, Lafley had ried to restore the balance in P&G's culture, which had suffered adly under Jager. He bought the Navy's discipline into the company, fostering competition in a once-collegial managerial culture. He learned during his days in the Navy that working hard and competing on everything pushes one to do better. So, in a company such a strategy motivates people who are performance-oriented and it also means that if one delivers he would be rewarded and if not, he is out. He also brought in some new concepts like the employee learning center to fix the culture at P&G.

Taming costs

As he got culture on track, Lafley also had to get expenses in line. Under Lafley, P&G is managing its costs better, which were the biggest problem. Costs had gone out of control under Jager, leading to a spate of profit warnings. So, Lafley eliminated about 9,600 jobs to cut down on expenses. Lafley's progress this far is quite impressive. His mandate was that managers couldn't spend more than they brought in or sold. It was a welcome departure from Jager's decree, of 'stretching' manager's sales forecasts and spending accordingly. Right from the time he took over, Lafley limited spending; he pulled back on some shipments in June, which hurt the overall numbers for the quarter but firmly re-established the message of "Big brands, big countries, big customers." He pinpointed problems, identified what needed to be done to rectify them and moved aggressively to make the necessary changes. Going by the history of P&G the company has been very slow to change in the past—laying off people was unheard of in the company. Cost-cutting was done mainly through attrition and retirement, and as a result it couldn't achieve the desired savings. But Lafley has impressively broken that mold.

Under Lafley, P&G is managing its costs better, which were the biggest problem

Lafley was also able to institute a concentrated effort of identifying and understanding the strengths in the company, spotting areas where it was sensible to exit brands. He was even successful in identifying products where P&G was weak and tried to execute a pullback or rollback strategy. Consequently, he pulled such flopped launches as Fit and Olay Cosmetics and also sold off units that weren't strategic fits. Led by him, the company has also reduced a lot of its factory space as part of a cost-cutting plan, saving millions of dollars. In fact, all these measures together resulted in savings of about $2 bn.

All this to good effect, because P&G has registered robust earnings in the past reported quarters and has been increasing market share through higher promotional and ad spending. It has beaten analysts expectations eight quarters in a row. In the June quarter of 2002 (also the end of the company's fiscal year), this consumer-product giant's reported net profits rose to $910 mn from a loss of $320 mn in the same period last year. For the fiscal year, net earnings per share rose nearly 52% over the previous year's. Fourth-quarter sales grew 6%, year-over-year and revenues for the full year are up 2.5%. For quarter ending in September, net profits were $1,464 mn as against $1,104 mn for the same period the previous year. Net sales rose by 10% over the same quarter in 2001. The silver lining being that all these promising figures were in the midst of a world economic slowdown.

Old is gold, new is silver

It is not that Lafley's strategy was ingenious or his predecessor Jager's strategy was defective. But Lafley's success is a result of recognizing that P&G didn't need a radical overhaul, all it needed was a renewed focus on its big-ticket brands. Jager, in his push for new products had neglected the company's older brands like Tide and Pampers. So Lafley refocused the company on its 10 bestsellers. These were the brands that brought in over $1 bn in sales each and together accounted for more than half of total revenues. (Today there are 12, after Iams pet food and Crest toothpaste were included.). Lafley reviewed each of P&G's big brands and every category in which the company competed. Three questions were asked for every product: Could it climb to No. 1 in its market? Could it be taken

global? Does it fit the emphasis on big brands? If not, P&G considered selling the product. Thus, many brands were shelved, including Clearsil, the world's leading acne treatment. And in less than two years, the company has replaced every dollar of Clearsil sales with more sales from brands such as Olay and Noxzema, its other skin care brands.

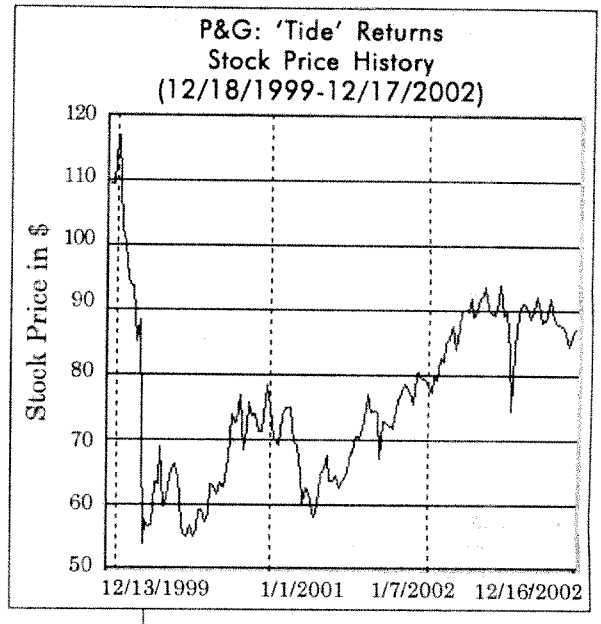
While cashing in on old brands, Lafley also worked towards launching new brands to drive future growth. Consequently, he reviewed the 'I-Fund', P&G's corporate innovation fund that included most of its new ventures. As a result, in baby care, Pampers has rolled out its Baby Stages line in Europe and North America. In laundry, Tide and Downy have new scents in the market. In feminine care, a new innovation at Tampax is on the way. And with a restaging of Pantene and Head & Shoulders, and the Clairol brands now in the fold, hair care category is also revamped. With a mix of new and old, the company has strengthened its position in global markets thereby boosting its bottom line.

With a mix of new and old, the company has strengthened its position in global markets thereby boosting its bottom line

Lafley's wisdom of concentrating on the core is borrowed from the basic strategy in Navy. When he worked as a supplies officer in the US Navy during the Vietnam War, he ran a departmental store for servicemen. There he learned that every business, including the complex ones, has a core and the core is what generates most profits. The trick, according to him, was to find the few things that were really going to sell, and sell as many of them as you could. As a result, he gave P&G a mandate—sell more Tide, which was easier than Jager's goal of finding a new Tide. This mandate was stretched to all the 10 later 12 blockbuster brands. And, it had already attained an expertise in this as it had been devicing new ways to sell Tide since 1946 and has been pushing Pampers since 1961. For P & G, which started the trend of 'new and improved' label on each of its product, the goal was all it needed to thrust forward.

For example, when Lafley took over, P&G's hair care group was struggling to get new brands to the market—its launch of Physique, a high-end shampoo brand, floundered while its dominant brand, Pantene, stagnated due to flat sales. Lafley renewed the focus on Pantene, making the job easier and less-frustrating. So, the hair care division started by refocusing the product on the benefit-of-use or the look achieved by using the product (for instance, volumizing, curls) rather than promoting it on the basis of consumer's hair type (normal, oily, dry). The company also changed Pantene's bottle to giving each hair treatment its own signature color.

As a result, volumizing products had a green cap. Further, new marketing materials at the point of purchase and other such tactics were used to boost sales and Pantene's sales grew 8% in 2001. Indeed the big brands strategy, which rides on the belief that new versions of old brands (Tide, Clean, Breeze has been a big hit) will win market share, has worked well for P&G. But, the company can't rely on them forever.



Blockbusters needed!

In due course, Lafley might have to do more than just sell more of the company's big brands to boost the company's top and bottom lines. More so because he has promised Wall Street a growth of 4 to 6% in annual sales by next year (in local currencies)—just as it did in the fourth quarter. He has also assured a continuous earnings growth of 10% or more. By reorganizing P&G, he has squeezed out $700 mn in costs savings this fiscal year, some of which has flowed directly to the bottom line, while some has been used to back promotions and price cuts for P&G mainstays such as Tide. So, for the time being he is doing fine, but things would get tougher as the cushion from the savings of a $6 bn restructuring venture started under Jager winds out and cost-cutting advantages wanes by the end of 2003.

Then there are other more niggling worries. P&G is generating growth in its existing brands through discounting. Which is why the sales in most last quarters inched up by just 2%, while unit volume rose by 4%. Lafley's strategy rests on the use of promotions to entice customers, who will then be persuaded to stay

P&G: Key Ratios			
	Avg. P/E	Price/ Sales	Net Profit Margin (%)
6/02	25.60	2.89	10.8
6/01	32.20	2.11	7.4
6/00	34.60	1.87	8.9
6/99	32.60	3.09	9.9
6/98	30.20	3.28	10.2
6/97	24.80	2.67	9.5
6/96	19.90	1.76	8.6
6/95	18.30	1.48	7.9
6/94	18.10	1.21	7.3
6/93	194.20	1.16	0.9

ith a brand as expensive versions 'e churned out. But it is a risky coposition as customers are loyal) sale rather than on the brand. nd the few brand loyalists might efer their purchase in anticipation f discounts. Furthermore, P&G's romotional strategy is heavily ependent on savings from its estructuring and division sales. ut savings won't last ng. P&G, which has avings to the tune of 700 mn this year, lready projects a fall 1 savings by 40% next ear.

In the long run, hus, it would need ew billion-dollar rands, something that ager knew but urried. Even Lafley nows the merits of ager's insight, but nlike Jager who wanted in-house nnovations, Lafley has embraced he 'open market innovation' i.e., ie buys innovations. Last Jovember, for instance, he bought Clairol, from Bristol-Meyers Squibb, for $5 bn—betting that the ast-growing hair-dye market will ring in a big revenue boost.

To keep its impetus, P&G lesperately needs some new lockbuster products. Recent roduct launches, like the Swiffer, in electrostatic dust mop, and Fit, a ruit and vegetable wash, have had epid success. And even though Crest Whitestrips, a tooth whitener deemed as the next big thing for the company, has raked in $100 mn in its first six months on the market, nothing has significantly boosted the company's overall sales. Further, as and when P&G establishes a new market, nimbler rivals quickly move in killing P&G's edge. Clorox Co.'s new ReadyMop cleaner, for instance, quickly edged the latest version of Swiffer.

Growing Procter

Today P&G has changed. As Finkelstein says, "P&G is more open-minded in considering opportunities than they were before, and are looking outside the firm for innovation as much as inside (a big change)." But all said and done, the company continues to stick to its long-term goal that calls for sales growth of 4-6% and profit growth in double digits on a percentage basis. Lafley is confident that the sales growth goal can be met without a major acquisition. But P&G is banking on one percentage point of growth each year coming from acquisitions, and Lafley is focusing the company on higher growth businesses like health care and beauty care. So, it might just need an acquisition to do the trick. Analysts believe that P&G is planning to bid for the 43.6% stake held by Allianz AG in Germany's Beiersdorf AG, maker of Nivea skin care products. Lafley is firm on the principle of acquiring only those brands that fit with its existing businesses and provide growth opportunities including geographic expansion. Some analysts see such a fit in the Beiersdorf deal. They say that it could help P&G in Western Europe, where its existing business has not performed as well as the company would like.

P&G is banking on one percentage point of growth each year coming from acquisitions

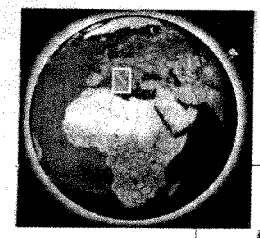
Lafley has proven to be a radical strategic thinker for the conservative P&G. When Kimberly-Clark launched a moist toilet paper last year, he went against P&G's mindset of 'make-it-here' and acquired a manufacturer of a similar product. This helped repel Kimberly Clark faster while engaging less money in the capital-intensive business. He had bought in the alien concept of outsourcing to P&G. He outsourced P&G's 6,000-employee, back-office operations through EDS, so as to strengthen his efforts to focus the company on its core and to keep costs down. P&G has outsourced in the following areas to outside companies—Employee services which include services such as payroll benefits, administration and employee assistance programs; information technology involving basically all computer and record-keeping functions of P&G; workplace services like facilities maintenance operations and customer service tasks like the 'help desk' and call center will be outsourced to other companies just like purchasing and accounting functions are outsourced.

But recently, in the first week of November P&G said that it is axing the multi-billion dollar sale of its back office operations to Electronic Data Systems (EDS). The terms of the deal (thought to boost the bottom line), which was stalled after a profit warning from EDS, called for P&G to sell its operations to EDS and contract it for back office support like payroll processing. P&G says, it will now outsource the back office services business to several companies, which still could include EDS.

The strategy is to seek multiple sources of service providers to minimize its risk. After all, better outsourcing deals would serve as the competitive advantage in today's turbulent times for FMCG companies.

C S V Ratna

Reference # 1-2003-01-16



Italy

The sixth largest economy in the world, Italy needs to continue the upswing by introducing more market-oriented reforms.

Italy, one of Europe's most important countries, is the sixth largest economy in the world after the US, Japan, Germany, Britain and France. Poor in natural resources, Italy's landscape is dominated by mountains and rugged hills, with some plains and coastal lowlands. Only about 30% of the terrain is composed of arable land. But despite these handicaps, Italy has made tremendous progress over the years. The country has some top class universities. Some of its scientists have even won the Nobel Prize.

Italy is divided into two main socio-economic regions: The North-Center and the South. The North-Center is the industrial heart of the country. This region has low unemployment rates and a well-built infrastructure. The economy comprises a few large corporations and thousands of small to medium, family-owned businesses. The South, also known as the *Mezzogiorno*, suffers from crime, high unemployment, and a poor infrastructure. State enterprises, (including those which have recently undergone privatization), dominate the economy in this region. Most of Italy's agricultural activities are in the South.

Post war Italy has been characterized by a weak political structure. Since 1993, Italy has had nine governments. But the country now appears to be moving towards a bipolar political system, dominated by the right-of-center Casa delle Liberta alliance, in power since June 2001, and the center-left Ulivo coalition. The May 2001 election result has reduced the influence of the smaller parties in the two coalitions. If Prime Minister Silvio Berlusconi, Italy's richest man is able to fulfill the promises he made prior to the elections, he may well become the first post war Italian leader to serve a full five-year term. Berlusconi has promised to speed up privatization, reform the state pensions system, introduce labor market reforms and reduce the role of the government.

Italy is a member of the Euro-zone. Unlike many other Europeans, Italians have not feared losing their national identity after the launch of the euro. This is probably because even 140 years after reunification, the country has still not developed a strong national identity. Many people also feel that Italy has been so badly managed that any alternative will be preferable. Moreover, many of the recent positive developments including increased competition, reduced red tape and growing privatization have been prompted by the euro. The general thinking seems to be that European institutions will impose necessary checks and balances on Italian politicians.

Background note

Despite massive destruction of its infrastructure, Italy rebounded from World War II quickly. The 1950s gave rise to an industrial boom that brought prosperity to the northern and central regions and shifted the focus from agriculture to manufacturing. Family-owned businesses became the mainstay of the economy. They focused on industries like textiles, machinery, and food processing.

But the State continued its interventionist role in the South. Large plants were constructed in the transportation, telecommunications, utilities, steel, coal, and petrochemical industries. But they created artificial jobs (not market-driven) and encouraged an unprofessional management culture.

Meanwhile, Italy continued to make progress toward its goal of

Table 1
Comparative Economic Indicators, 2001

	Italy	Germany	France	Spain	UK
GDP (% real change)	1.8	0.6	1.9	2.8	2.2
GDP (US$ bn)	1,090	1,848	1,312	582	1,511
GDP per head (US$)	18,950	22,500	21,960	14,463	23,750
Consumer price inflation (avg; %)	2.3	2.5	1.6	3.6	1.2
Unemployment	9.4	9.5	9.0	13.1	5.0
Current-account balance (US$ bn)	2	4	26	-15	-23
Current-account balance (% of GDP)	0.1	0.2	2.0	-2.6	-1.6
Exports of goods fob (US$ bn)	242	571	289	118	275
Imports of goods fob (US$ bn)	-224	-488	-283	-149	-323

Source: Economist Intelligence Unit

European integration. In 1979, it became one of the eight European States to join the European Monetary System (EMS).

In 2001, Silvio Berlusconi's Forza Italia (Go Italy) party won the elections with a handsome margin. His attempts to reform Italy's labor laws led to a day-long general strike by the country's three main trade union groups. This was the first of its kind in 20 years. The strike put Berlusconi under pressure, his earlier government having fallen in 1994 after mass demonstrations.

Some of Berlusconi's recent actions have not impressed observers. He has frozen the prices of an array of public services, blocked a hike in electricity tariff and reduced the independence of the country's energy regulator. During the period 1992-2001, Italy sold off assets worth £113 bn. But since March 2001, Berlusconi's privatization initiatives have generated only £235 mn. The government which is having stakes in various businesses is finding it difficult to let go. The treasury still owns one-third of ENI, the energy group, over two-thirds of Enel, the electricity group and 4% of Telecom. The government is not able to make much headway in the area of pensions which account for 25% of the GDP and 40% of the public sector spending.

Economic and social policies

In recent times, Italy has embarked on a journey of wide ranging economic reforms. It has focused on cutting taxes, tackling unemployment, enhancing competitiveness and reducing the budget deficit. But Italy's large bureaucratic government has sometimes made it difficult to implement market-oriented reforms. Economic and cultural differences between Italy's North and South regions have also hindered the development of a market economy.

Italy is also one of the more corrupt countries in Europe. Berlusconi's own less than perfect record when it comes to business ethics is a major cause for concern in this regard. Italy is considered the least transparent among the G-7 countries in its business practices. Transparency International has put Italy along with Greece at the bottom among the countries of Western Europe. It is probably because of corruption and the opaque legal system that Italy is unable to attract enough foreign investment for an economy of its size and sophistication.

Industry

Like most other advanced OECD economies, Italy has a small primary sector. Services contribute close to two-thirds of gross value added. Italy is strong in manufacturing, which accounts for about 25% of GDP and about 90% of Italy's total merchandise exports.

Italy is dominated by two tiers of private companies. The first tier consists of a few large family-owned companies. The second tier of Italy's dual economy consists of clusters of family-owned Small and Medium-sized Enterprises (SMEs). These firms specialize in products that require high-quality design and engineering.

Italy has few large private companies, but those that exist play a major role in the economy. They include Fiat, controlled by the Agnelli family; Pirelli, controlled by the Pirelli family; and Fininvest, controlled by Silvio Berlusconi. The families have generally exerted control, with a relatively small shareholding, through holding companies and cross-shareholdings with industrial and financial allies. This has begun to change slowly with the introduction of legislation that requires greater transparency by listed companies and improved minority shareholder rights.

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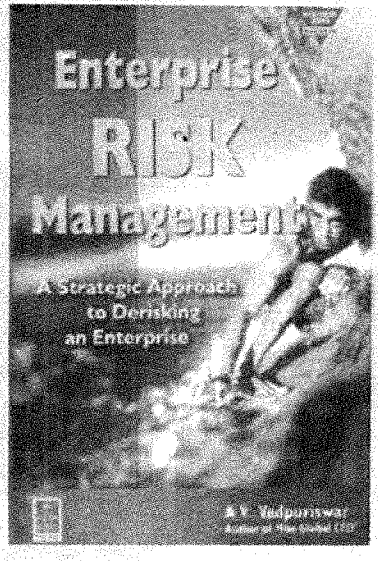
Reference # 1-2003-01-17

Enterprise Risk Management

A Strategic Approach to Derisking an Enterprise



Author: A V Vedpuriswar
Pages: 520
Price: Rs. 595.00
Publisher: Vision Books

Businesses are today operating in a high-risk and unpredictable environment. The increased complexity of businesses has also increased the risks companies face. Proper risk management demands an integrated enterprise-wide risk management approach rather than a piecemeal approach to tackle risks.

The explicit purpose of a company is to achieve growth and no company can do that without taking some rational, and reasonable risks. In the words of Peter Drucker, a company that does not take any chance is incurring the biggest risk that of not taking any risk at all. So risk cannot be avoided, what can be done is managing it. Thus risk management becomes the prime concern of companies. Risk management in a broader sense encompasses the various kinds of risks faced by a company including non-financial and non-quantifiable risks. Risk management is all about making a trade off between choices. Prioritizing risks and preparing contingency plans to tackle it would help the organization in efficient risk management.

Thinking strategically

In an ever changing world only those organizations succeed that are sensitive and responsive to the needs of the customers in the changing environment. For instance Nokia, the maker of sleek cellphones was once into wood, pulp and paper business. It changed and survived for over hundred years. Shutting off its eyes and ears to the changes in the marketplace would only ensure its downfall even if it were a great company once. The essence of risk management is to survive and grow; survive amidst uncertainty and grow when things are better. Planning a strategy to deal with uncertain times poses a number of problems. One way to overcome the obstacle is to use scenario planning. Understanding the various possible scenarios and preparing to deal with them would give the company an edge in dealing with the unfolding scenario.

Strategic moves of a company may be divided into three broad heads, capacity expansion, vertical integration and diversification. Risk in capacity expansion is high when industry has excess overcapacity and when capacity can only be increased in great leaps. Also this strategy

eeds huge investments. Toyota ıd managed this risk by using exible manufacturing systems, hich reduced the time and the vestments as well. When it comes vertical integration many ımpanies are faced with the ıestion of 'outsource' vs. ıanufacture'. In case they go for ıtsourcing the points to be kept in ind to minimize outsourcing risk 'e, not to outsource activities that re central to its competitive ɔsition, not to outsource if ıppliers are few in number unless ıey are extremely reliable and to void dependence on suppliers. ɔncentration on single product, ervice or customer could prove trimental to the success of the ısiness. Sticking to the old adage not keeping all the eggs in one ısket, it is better to spread out if ıe were to survive under all rcumstances as GE has done.

he other side of technology

ıe pace at which technology is ıanging these days, a chnological breakthrough could reck havoc on the established ısinesses dependant on an ɔsolete technology. The risks in chnology arena fall into two tegories, the first is the erenthusiastic ones who jump ıto the technology too fast and ırn their fingers. The second is ıe other extreme where a mpany waits and watches as ıother company comes up with e new technology. Either ways it uld prove to be disastrous for a mpany. Some companies have olved with an innovative culture, ıt it is to be kept in mind that all novations might not prove to be ually successful.

Taking new technologies to the arketplace involves the following eps: Imagining, incubating, monstrating, promoting and staining. A new technology could a sustaining technology or a sruptive technology. A sustaining chnology is one that enhances mpetency, comes up with ıprovements for the existing products and also suits well with the existing technology. Such an innovation may come from existing players or outsiders. Other competency-destroying innovations or disruptive technologies almost always are spearheaded by outsiders. Disruptive technologies bring in a different value proposition, which are not compatible with the present technologies. In order to manage technology risks, the firm must watch inflection points, points of sharp discontinuity when customer needs are more than satisfied and the differentiated offerings of existing players lose their meaning. A new mindset is necessary for managing radical innovation.

M&As and strategic alliances – New risks

Mergers and acquisitions bring about enormous changes in the operations of companies. A new company generally grows out from the combination and for it to be successful it is necessary that synergies be identified between the merging partners, and the value of the bought out company is arrived at in the most accurate manner. In addition, the process of integration should be so planned and implemented that it smoothens the ruffles and prepares the ground for common operations, integrating the work culture etc. The merger would prove to be disastrous for both the parties if a well-integrated organization that is better than the earlier entities does not emerge. Cultural differences and implementation of the integration plan form an important part in managing acquisitions. Antitrust issues are yet another aspect of mergers and acquisitions that poses enormous risk. For example, in the case of GE-Honeywell merger the merger was not allowed by antitrust authorities. Strategic alliances, though offering more flexibility than mergers and acquisitions have their own set of risks. One of the biggest risks in strategic alliance is the unintended leakage of knowledge. The risks in strategic alliances can be minimized by a systematic and pragmatic approach at the negotiation stage itself.

Environmental and political risks

Environmental risk may be defined as the possibility of degradation of the environment owing to human activities resulting in direct or indirect harm to people. However, for many companies environmental concerns are not in the same genre as other risks. For many, it is not directly related to business but imposed by law. The best way for companies to handle environmental risk is to look at it as yet another business risk rather than limiting it to regulatory compliance. Investing funds in minimizing damaging impact on the environment would improve companies' competitive position. But a balance needs to be maintained and locking excess funds in environmental risk management would be unwise. The best way would be to incorporate concerns of environmental impact in the overall processes and design them with this in mind.

Political risks include actions taken by the Government or political groups, which can influence the way business is conducted and transactions are done. Political risk is an important consideration for companies that are expanding overseas. A lot of their work is dependant on

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permissions and other procedures dictated by the government's rules and regulations. Though it is largely believed that poorer the country, higher the risk, the recent attacks on the World Trade Center, located in the US prove otherwise. Country risk assessment includes issues such as economic and social performance, the country's goals and policies etc. Companies can minimize country risk by keeping control of crucial elements of operations, sharing ownership partially with the local people, participating through joint ventures etc. Raising debt in the host country is yet another tactic that can be adopted by companies to minimize the chances of expropriation. An understanding of the government's point of view on important issues also helps in minimizing political risk. Specific risks in international business include kidnapping key personnel, terrorism, crime, corruption and bribery. *Euromoney*, a famed magazine, provides country risk ratings, which give an insight into the risk profile of various countries.

Ethical, legal and reputation risk

The rise of investor awareness and the increasing importance of ethics and corporate governance issues pose another area of risk for companies. When a company acts unethically or at least is perceived to be acting unethically it attracts class action suits, investigation by regulators such as SEC and puts its reputation at stake. Allegations such as insider trading, price rigging etc., not only affects the reputation of the company but also have an impact on the business of the company. Product liability also forms a part of the legal risk. Such liability arises when the product supplied is defective. In general product liability judgments favor plaintiffs and substantial awards for both economic and non-economic damages. In numerous cases such as Johnson & Johnson, Ford, Coke etc. the companies went in for a recall of the defective products in order to save their reputation. Such product recalls also needs to be managed with great care and the public face of the company needs to be maintained beyond reproach. It is better to admit an error rather than ignoring it if the company has to retain its reputation and the trust of its customers.

Antitrust laws create another dimension of risk for huge companies. This legislation differs considerably in the US and Europe. In addition to the bad publicity and press, this could create the risk of being asked to split the company. One good example of a company that was pushed into the antitrust muddle but survived and thrived is Microsoft. Antitrust allegations had almost toppled the company but Microsoft was undeterred and continued its business as usual. And as luck would have it the decree to split up was reversed in favor of Microsoft.

Financial and marketing risks

A firm is exposed to financial risk when the value of its assets, liabilities and operating cash flows are affected by financial parameters such as interest rates, exchange rates, stock indices etc. The aim of financial risk management is to reduce the volatility of earnings and increase the confidence of investors. There are various types of financial risks, credit risk (the possibility of default by a borrower), market risk (it includes interest rate fluctuations, currency rate fluctuations, commodity risk), liquidity risk (the mismatch between assets and liabilities). The four steps in financial risk management are identification and quantification of risks, framing of policies to transform the risk into a form with which the company is comfortable and finally implementation and control.

Four broad ways in which financial risks can be dealt with are: Avoidance, where a firm can avoid holding financial assets and liabilities, whose value is uncertain; loss control in the case of risks that cannot be avoided by undertaking specific policies; diversification, wherein a firm may distribute its assets and investments in various places rather than concentrating them in one place; finally transferring the risk to a third party. It is possible that the company might retain the asset/liability but transfer the risk or the company retains the risk but in the case of loss a third party assumes the liability. The use of derivatives comes in the last strategy of transferring risk. Futures, options, swaps, forward rate agreements etc., can all be used effectively to transfer risk. Insurance is yet another way to transfer the risk of loss.

Snapshot

- Enterprise-wide risk management is a must for companies that want to make it big in the complex and dynamic business environment.
- In the case of technology risks established companies have to strike a balance between sustaining and disruptive technologies. They should always be alert in terms of technology innovations happening in their field.
- Mergers, acquisitions or strategic alliances come with their own set of risks. A dispassionate analysis of the potential benefits and pitfalls would help in minimizing the risks.
- Managers should look at better environmental performance as an opportunity rather than a threat.
- Managing of political risks requires a good understanding of the economic, political and socio-cultural factors.
- Strategic planning lays the foundation for effective risk management since it provides a broad road map for an organization based on the company's internal profile and the characteristics of the external environment.

Building and safeguarding the and has become one of the top ost priorities of companies today here product differentiation is iminated as competitors catch up no time at all. Wrong mmunication strategies can lute or even harm the brand. In ldition, a company also faces arketing risk when its stribution channels wield high ırgaining power. Marketing risks fer to the uncertainties involved designing and implementing the arketing mix. It would pay for a arketing manager to have a ıorough knowledge of the stomer base such as who are the yal customers, who are likely to ıift to other brands, which ·gment is sensitive to economic ·cession. Building brands has rtain inherent risks such as a iled advertising campaign, which ight reduce the brand loyalty of ıstomers. Online advertising, the cent offshoot of the Internet, is ·t another risky proposition. In ıe case of many dotcoms, online lvertising proved to be disastrous. was the biggest expense head and the same time did not lead to an crease in sales as expected. A ·and is perhaps the biggest asset ıat companies can nurture and aintain in today's era. And millions dollars are poured into the job ıd it needs great care and diligence carefully creating the brand.

Launching new products is quite ·pensive and risky and there could ·· various reasons why the new ·oduct fails such as overestimation the market size, poor product ·sign, wrong positioning, over-·icing, uninspiring lvertisements, higher than ‹pected costs of product ·velopment and aggressive ımpetitor response. Strong new ·oduct planning is needed to ıprove the probability of success new products. The ideas for new ·oducts should be subjected to a ıorough scrutiny and only those ·oduct ideas that are based on a ·ecific strategic role of the product ıould be accepted.

Creating an environment responsive to risks

The economy today is transforming into a knowledge-driven economy and the quality of manpower makes all the difference between the success and failure of a company. Each critical activity of the HR function poses a different risk. Consider succession planning, indisputably the most important strategic function of HR. One wrong choice in the selection of a successor to the CEO could mean a great loss to the company. In the case of Westinghouse, a series of wrong CEOs virtually drove the company that was once rated on par with GE into bankruptcy. GE is one of the few companies that has been successful in grooming leaders. The successor is selected and well-prepared before he actually gets into the job thus ensuring minimum disruption due to a sudden change in leadership or due to new hands on the job. A foresight to anticipate the future needs of the company and planning for manpower keeping the broad vision of the company in mind would go a long way in minimizing HR risks.

Another important HR responsibility is to attract and retain talented employees. Retention rate can be improved by building an ideal work culture, assessing potential candidates using careful hiring practices, understating the issues driving retention, ensuring that employees get a well designed career-development plan and an attractive and transparent reward system. Aligning individual goals to the organizational goals would also help in minimizing the risks in HR arena.

It has to be firmly understood that risk management is not the prerogative of one specific department or only the responsibility of the top management. An enterprise-wide awareness of risk and managing it as well as systems, processes, procedures tuned to risk management is necessary. The role of the senior management of a company is very important in establishing such a culture in the company. The top management should understand the risk profile of the company, set policy guidelines to take action when things go wrong, establish control mechanisms and set up systems that consolidate and integrate data from various departments of the company. One way to ensure that all these issues are handled efficiently is to create the post of Chief Risk Officer (CRO). Knowledge sharing across the organization could make the process of managing risk easier.

Peeping into the future

It is only since the mid-1990s that risk management has been recognized as a distinct discipline. And now into the new millennium, many companies are implementing sophisticated risk controls and are consciously attempting to address risk on various fronts. An attempt is also being made to reorient the risk management department into an internal consulting practice of the company. An integrated risk management approach is the need of the hour. Such an approach would identify and assess the risks of the company as a whole and formulation and implementation of a company-wide strategy to manage them. Decisions should be taken as to which risks should be retained and which to be transferred. Certain crucial risks such as risk to the firm's reputation, risk of losing talented employees, risk of being caught unawares when a new technology emerges and the risk due to strong competition cannot be delegated or transferred. They have to be handled by the top management of the firm itself. A dedicated and enlightened top management would be successful in managing various risks if it adopts an integrated approach to risk.

D G Prasuna

Reference # 1-2003-01-1B

Opening of two new ICFAI Offices

We are happy to inform that ICFAI has opened two new offices in the cities Ludhiana and Thiruvananthapuram with the objective of providing programs information, counseling, administrative and other services to the existing and prospective students of ICFAI. The students of Ludhiana and Thiruvananthapuram are welcome to contact the ICFAI Office for clarifying queries and getting other services at the addresses mentioned below:

LUDHIANA	THIRUVANANTHAPURAM
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The Convocation, 2002 of ICFAI

We are happy to inform that The Convocation 2002 of ICFAI was held on December 21, 2002 at Hotel Taj Residency, Hyderabad. Dr. Abid Hussain, India's Former Ambassador to USA, Former Member, Planning Commission, was the Chief Guest. Dr. A Besant C Raj, Chairman, ICFAI, blessed the graduating class. In this Convocation, about 147 students received the PG Diploma in Financial Analysis from ICFAI in person and absentia leading to the CFA Charters from the Council of Chartered Financial Analysts (CCFA), and about 439 students received the PG Diploma in Business Administration from the ICFAI Business School and membership certificate from IBS Alumni Federation (IBSAF), in person and absentia.

83 students received the PG Diploma in Management from the Icfaian School of Management and MBA Certificates from Transworld University, USA. 44 students also received the Masters Diploma in Computer Applications from the Icfaian School of Management.

79 students were conferred the designation 'Certified Treasury Manager' (CTM) in person and absentia.

Gold and Silver medals, Merit Certificates and Cash Prizes for outstanding performance in the CFA/PGDBA/MBA examinations were awarded to the winners.

Examinations, 2003

The next examinations for the PGDFA program will start from January 04, 2003. The admit cards of the eligible candidates who are registered for the examinations have been mailed and also placed on the website **www.icfai.org** for download. Candidates who are eligible to take the examination but not registered by December 16, 2002 can utilize the walk-in registration facility to appear for the examination subject to the availability of seating capacity and question papers at the test center. Candidates availing the walk-in registration facility are required to be familiar with the rules and regulations given in the ICFAI Candidates Regulations 2002.

Registration of Mobile Phone Numbers with ICFAI

ICFAI is contemplating to send urgent information to the students through SMS on the mobile phones of the students for faster communication. In view of this, students are advised to register their mobile phone numbers with the Student Services Department of ICFAI. They can send E-mail to Student Services Department at **ssd@icfai.org** to register their mobile phone numbers. We hope that students would register their mobile phone numbers and take advantage of the facility.

Annual Service Charges

Candidates of the DBF/PGDFA Program who are enrolled on or after April 01, 2000 may note that they are required to pay Annual Service Charges every year. The period of one year is reckoned from the date of enrollment.

With effect from April 01, 2002, the candidates are required to remit the Annual Service Charges before 1st of the month in which the service charges become due for payment. A late fee of Rs. 100 per month is charged in case of delay in remitting the Annual Service Charges.

All candidates who have enrolled in the DBF/PGDFA program on or after April 01, 2000 and not yet remitted the Annual Service Charges for the year 2001/2002 and/or 2003 are required to remit the Annual Service Charges with a late fee of Rs. 100 per month. Annual Service Charges can be remitted using Form 110 of the ICFAI Candidates Regulations, 2002.

The candidates, who do not remit the Annual Service Charges, will be denied all the student services without further notice.

List of Holidays

ICFAI will observe the following occasions as holidays during the year 2003.

Date	Day	Occasion
January 01	Wednesday	New year
January 14	Tuesday	Sankranti
March 19	Wednesday	Holi
April 02	Wednesday	Ugadi
April 11	Friday	Sri Ramanavami
August 15	Friday	Independence day
October 02	Thursday	Gandhi Jayanti
October 03	Friday	Durgastami
October 04	Saturday	Maharnavami
October 25	Saturday	Deepavali
December 25	Thursday	Christmas

In addition to the above, Second Saturday of every month will be a holiday. However, in lieu of Second Saturdays in January and August 2003, ICFAI will observe the following two days as holidays:

Date	Day	
January 13	Monday	(in lieu of 11-01-03)
August 16	Saturday	(in lieu of 09-08-03)

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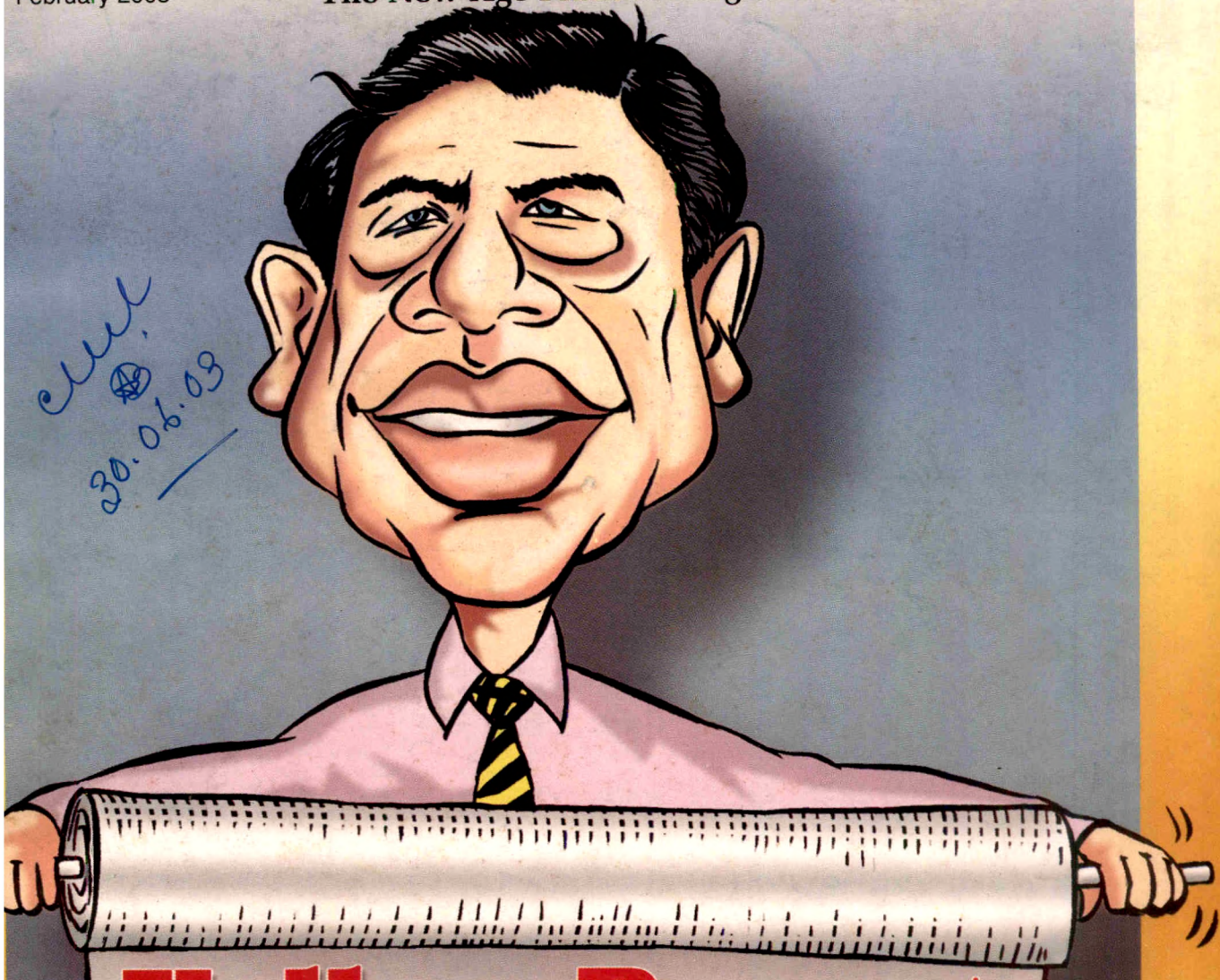

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Vol-IX, Issue - 2 February 2003

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Simplification Conundrum

"In this world nothing is certain but death and taxes" goes the adage, but certainty has an additional element of complexity in the context of Indian economy. Like many other legislations the tax law grew very complex over time. The need for reform in this area has been all too evident, ever since India embarked on the path of reform. Complexity apart, the efforts to improve tax buoyancy and better compliance have been on the back burner for a long time. Our corporate tax rate compares with the highest in the world. The tax to GDP ratio has been declining. Kelkar's prescription had to address these issues in its revamp package.

The long awaited package was made public. Important recommendations include raising the minimum exemption limit, clear the maze of rebates and deductions, switching over to a two-tier structure etc. Most of the measures mark a wide departure from the established practices and experienced mixed reactions.

To understand the implications of the proposals one needs to go beyond the obvious. The existence of tax rebates and deductions virtually dictated the investment choices of individuals by distorting the true yields. At times, corporate decisions were suboptimal owing to the lure of tax sops rather than business rationality.

The channelizing of savings by the visible hand of the government would be replaced by the invisible hand of the market once tax rebates vanish. While it would initially have an adverse impact on tax-sheltered instruments, in the long run it would result in resource allocation based on yields.

The multitude of rebates and deductions have traditionally ensured that the effective rate of taxation is much lesser than the nominal rate. This is likely to change. The process of tax reform is bound to be painful but nevertheless is a necessary medicine for India's economic ills. The fate of the Kelkar recommendations will be subject to the political will to implement them.

As India gears up for the forthcoming budget, expectations abound to make India Inc. deliver 8% growth. Transparent and simpler tax regime, restructuring of state finances, empowering the banking sector in handling acquisitions, NPAs etc. and speeding up the disinvestment process are a few of the major proposals. While it is largely agreed that India has great potential, the pace of reforms is identified as one of the main determinants to realize the dream of an economic superpower. The agenda is clear but the moot point is the political will. One can only hope for fiscal prudence to prevail over vote bank considerations. Is FM listening?

Ch Rajeshwer

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ABB – Prudence is a Virtue

Call it a coincidence or blame it on Enron, suddenly a sense of crisis seems to have gripped big businesses. While corporate America has a problem of plenty, with the list of troubled companies (Enron, WorldCom, Global Crossing, Adelphia...) getting bigger and murkier, others like Europe and Asia too have had their share of it. The question is—is the coincidence has something to do with the general weakness in the economies worldwide or is it just a curse of bigness?

It appears that there are two categories of troubled companies—one, that is marred by an adverse business environment globally while, in the second category there are the companies misguided by the greedy executives, supported well by shrewd accountants. Enron and WorldCom fall under this second category. However, it is the first category where there exists a very thin line between the victim of a slowdown and that of a poor strategy. Perhaps companies like ABB could fall in that category.

In the heydays of the stock market boom during the early 1990s, many big companies from America and Europe got into the race to satisfy market's appetite for faster and quicker growth, which in turn would reward them with big jump in their share prices. ABB, the Swiss-Swedish engineering conglomerate was one such example. It went for a slew of mergers and acquisitions deals, involving some big-ticket deals like one with Alstom of France and another with DaimlerChrysler of Germany. The growing media adulation and market's cheering for his charismatic leadership prompted Barnevik to pursue something different. He went for diversifications into areas hitherto unknown and mostly unrelated such as power generation and railway transportation to ABB's core businesses. Today, the venerable giant is struggling for its survival, and its strategy, of being local worldwide (referring to greater local autonomy inside the framework of a large multinational firm), is in shambles. On the contrary, its peer Siemens, another European conglomerate, stays fit.

Siemens' strategy of staying focused on its core businesses and sticking to its 155-year-old tradition of prudence has paid off well for the company in these turbulent times when its peers finding it difficult to perform. The numbers speak it all: Siemens reported a net income growth of 24% for the fiscal 2002 ending September 2002 whereas ABB was in the red during the nine-month period ending September 2002. The biggest lesson one can probably draw is, future belongs to those who believe in the virtue of prudence—be it new economy businesses or old economy ones.

Amit Singh Sisodiya

Disinvestment Saga

Soon after independence, Pandit Nehru heralded an era of public sector companies describing them as the 'engines of growth' and development of the Indian economy. By the early 1990s, India's political elite realized that these so called engines had become the biggest drag on the Indian economy. They were consuming huge amounts of scarce resources especially in the non-strategic sectors even by the government's own admission. With an intention to minimize, if not eliminate, the role of the government in managing and conducting businesses directly, the disinvestment program was initiated as one part of the economic reforms, which began in the decade of the 1990s.

Even after a decade of economic reforms, the Government of India is yet to evolve a proper method of disinvestment. Each time the issue of disinvesting a public enterprise arises, there is a hue and cry on the methodology adopted. Till now, the total number of disinvested PSU is around 50 but the method remains a controversial issue. Whether it should be a strategic sale or an open offer remains a point of debate thus delaying the process further. Instead of deciding on the mode of disposal on a case-to-case basis, a better option would be to have certain standard procedures to be adopted for these disbursements.

Year after year ambitious targets of disinvestment have been set but were never achieved. The target of Rs. 12,000 cr which was set for this fiscal had become some kind of a national joke with almost nobody believing it. Instead of a well planned disinvestment, it has been observed that during the end of the fiscal, a quick disbursal was undertaken in a desperate attempt to meet the target. This kind of an attitude has adversely affected the proceeds of disinvestments.

Another contentious issue has been the disinvestment of profitable PSUs. Many argue that a profitable PSU should not be disinvested. But in this regard it is worth noting the underlying principle of disinvestment. The government has no interferance in business except as a facilitator and so whether the disinvested PSU is making profit or not should not be the decision criteria. In addition a profit-making PSU could actually get a better price and enrich the coffers rather than a loss-making PSU.

Even as India discusses the second phase of reforms, disinvestment remains a problem prone area. Lack of clear strategy and political unwillingness have been the major culprits for the situation. The slack pace of disinvestment has been a major concern for India's competitiveness in international business arena.

D G Prasuna

CFOs – Transform and Survive

Traditionally, Chief Financial Officer's (CFO) role has been that of a controller—responsible for less exciting, yet important things like budgetary controls, treasury operations, and preparation of financial statements. However, with rapid globalization of businesses underway and the need to tap capital from global investors becoming all the more crucial, traditional view of the CFO as a corporate police officer stands changed.

In this rapid changing environment, role of the CFO is becoming more critical as demands made on finance functions change and increase. Now, CFOs are thrusted with the responsibility of shaping the future of their company as a strategic business partner. Their responsibilities are defined more broadly and strategically than ever before. With an increasingly challenging business environment, a CFO is expected to be a strategic partner with the CEO in guiding the future growth and development of business.

Today, CEOs are looking for innovating CFOs who have the ability to think outside the box. They are required to help chief executives establish the value system within a company and provide proper focus and prioritize business objectives. The CFO is also expected to partner with the Board and act as its advisor in creating and enhancing stakeholder value.

Another key development that is shaping the role of a CFO in the new century is information technology. Today, information is more readily available than ever before. The CFOs are required to be aware of, understand and be able to analyze and evaluate how technology change is going to impact business. They need to communicate to the management team what those changes are and develop creative ways to address them. Now companies want the CFOs to be almost a 'Super-CFO', placing a full-time effort on each aspect of the job. The CFO is expected to create shareholder value by delivering on numbers, act as an in-house venture capitalist and challenge business managers to generate value.

The CFOs' role in corporate governance has heightened with the current crisis of confidence in financial markets across the globe. Accounting scandals, restating of reported financials, questionable off-balance sheet transactions and lack of basic corporate governance have led to this crisis. All this means that in the new environment, the CFO must be a multifaceted visionary who works hand in hand with the CEO to achieve the company vision and enable the long-term success of the company.

N Janardhan Rao

Tax Reforms Impasse

Indian tax laws are being perceived as one of the complicated tax laws internationally. Though attempts were made to reform the Indian tax regime, they did not materialize. The latest Task force prescription has some suggestions that can ultimately change the face of the Indian tax regime. However, there is a furore over some of the suggestions especially from the salaried class and the political parties.

The major bone of contention relates to the issue of removal of existing exemptions, raising the exemption limit of income tax and doing away with the housing sops. According to the Task force the multitude of exemptions/ rebates operating under Sections 10, 80 and 88 have reduced effective tax rate and buoyancy of the revenue. At the same time, these have also increased the administrative complexities. The Task force strongly argues that in order to make the tax system more broad based, revenue buoyant and simple, it is important to do away with such exemptions/rebates.

However, fears are being expressed that if the minimum exemption limit is raised to the proposed Rs. 1,00,000 as many as 40% of the existing taxpayers will go out of the purview of income tax. Though the theory of taxation supports the concept of minimum exemption limit, raising it too far may lead to a drastic fall in the tax revenues. This is not definitely warranted at a time when the tax-to-GDP ratio is constantly declining. The shortfall in revenue will be compensated by removing tax rebates available to senior citizens, standard deduction and other tax rebates/exemptions available for savings.

To make personal income tax and corporate taxes equitable, individuals are entitled for a predetermined standard deduction. While the Task force has attempted to simplify the tax administration, there is a general feeling that it has forgotten the logical foundation of standard deduction and minimum exemption limit. Though the recommendations are aimed at simplifying the tax regime and ultimately improving tax administration in India, the implementation of it remains doubtful. With a strong opposition from both individuals and political parties, the recommendations have to incorporate some sweeteners before they are implemented. The political parties are not willing to implement any reforms that can destroy their vote banks, especially with the elections round the corner. Only a handful of suggestions might be implemented. This will end the dream of having a simplified tax system in place as any reforms have to be implemented as a whole rather than in bits and pieces. Perhaps, the coming Union Budget will indicate the fate of this report.

Y Chandra Sekhar

Letters to the Editor

Words of Appreciation

I saw the article on BPO in the January 2003 issue of *Analyst* on the ICFAI Press website. The article was informative and relevant. I appreciate the efforts put in by the team.

Pankaj Jain
Sr. Executive – Relationships,
www.ibackoffice.com

Good Series

I am a regular reader of *Analyst* magazine and I would take the opportunity to congratulate the team for publishing an excellent series of case studies on Turnaround. It is very interesting as well as informative to know how companies such as IBM or P&G were effective with their turnaround strategies.

B Ranjana Sethi
Ahmedabad

Interesting Debate

The debate on India's chances to achieve a growth rate of 8% was very good. Everybody knows that India has a lot of potential but it falls short when it comes to implementation. If our political leaders become alert and concerned about the economy, India can become a star performer in the international economic scenario.

K S Prakash
Chennai

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CHARTERED FINANCIAL
ANALYST

Cartoon Corner

YOU SAID IT by Laxman

From where did you get those crackers, boy? If George Bush comes to know you will have no end of troubles!

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Verbatim

We are very clear in our mind we must enhance production, increase GDP, put more money in citizens' pockets and housewives purses...Growth through reforms is government's priority.

Jaswant Singh, Finance Minister on the forthcoming Union Budget proposals.

We feel that with all the stability looking good, there is an unusually good opportunity for the government to take steps that will accelerate growth and boost it to 6% now and more later.

A C Muthiah, President, FICCI on performance of the Indian economy.

I believe that economic growth follows infrastructure. If a company or country is to have a strong economic growth, it needs a strong, integrated infrastructure.

Phil Condit, Chairman and CEO, Boeing Company on economic performance vs. growth

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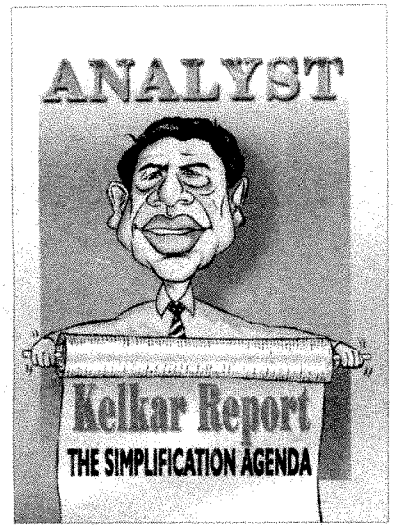

Cover design by Bangaru Babu A; Illustration by S Ganesh

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The Kelkar Committee has recommended big bang tax reforms that will make the Indian tax structure more broad-based, revenue buoyant and more equitable. The reforms package emphasizes on self-compliance, nominal tax collection and tax compliance costs and advocacy of taxpayer services. Though the suggestions are broad-based, opposition from certain sections of the population may defer the actual implementation.

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GE, the most admired company led until now by its most charismatic leader Jack Welch, is no longer seen as a growth machine. Amid a tepid global economy and big size, the company might not be able to enjoy that double-digit growth which it achieved in the past. Pressure is growing on GE to break the company into smaller entities.

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NATIONAL

GDP – increase by 5.4%

The GDP growth in the current year will be at 5.4%. This will be possible provided agriculture performs reasonably, particularly rabi crop. The industry will definitely slowdown to about 6% growth and services will also, after a considerable period, decelerate to less than 7% growth.

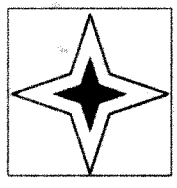
According to B B Bhattacharya of the Institute of Economic Growth, economy may grow at about 6% per annum in the next three years (2001-02 through 2003-04). Services would be the most dynamic sector with an average growth of 8% plus. The industry on the other hand may grow at a moderate rate of about 6% per annum. "If rainfall becomes very favorable and international oil prices decline from their current high level to a more sustainable level, then the economy may grow at a faster rate of 7% plus in the medium run." The investment rate continues to fall to 21.3%, he says adding that the inflation rate would accelerate to about 7 to 8%, mainly due to a rise in the fuel prices.

Silicon Valley – Indians lead

US President Bill Clinton has opined that he was 'stunned' and 'worried' by the fact that over 700 firms in the Silicon Valley are owned by Indians in the information technology sector. "I worry about that...If you just take the information technology area...There are 700 companies today, in the Silicon Valley alone, headed by Indians. It was just stunning, you know," Clinton told the latest issue of the *Science* magazine. He also suggested using US, with its 'enormous infrastructure', as a 'global lab'.

"I think there needs to be a way for us to try to share both scientific and the economic benefits of our enormous infrastructure here. I'd like to see the US used...As sort of a global lab, but with the ability to send our folks back out, send their people — (who) come here — back out, finance education and research exchanges, and even... operational exchanges", says Clinton. He also expressed fears with respect to the impact on global warming, as India and China develop their economies. "If India and China have to grow wealthy the same way we did (by guzzling enormous amounts of fossil fuels), since they will not give up the right to become wealthy, we're not going to whip this climate change problem".

Diamonds dazzle world market



Maintaining its scintillating performance this year, the gems and jewelry industry has emerged as a major forex earner with exports scaling a new high of $8.025 bn during 1999-2000, a growth of 30.11% over the previous year. India consolidated its position further in the international diamond market by supplying over 80% of processed gems, imported in rough form, largely from Africa. The diamond sector not only improved its world market share from 50-55% in terms of value but in terms of carats and pieces exported, it continued to be way ahead with a share of 80% by caratage and 90% by pieces. The industry grew by 14% to $3,565.3 mn during April to September 2002 this year as compared to $3,208.14 mn for the corresponding period last year.

The performance in the last fiscal surpassed even the highest expectations as also the target of $6.716 bn set for the year. The cut and polished diamond segment registered a 10.43% growth with exports touching $3,169.7 mn during the first six months of the current fiscal as against $2,870.12 mn till September in the previous fiscal.

Outsourcing giant

Surging revenues, strong profit growth, lucrative new contracts and a massive recruitment drive—can this really be the information technology industry in 2003? Yes, provided you are in India, where software firms are flourishing thanks to booming outsourcing business from some of the world's leading multinationals, says *The Economist* magazine.

Though the Indian outsourcing industry was heavily hyped a couple of years ago, its current strength reflects something of a recovery after a tough time at the start of the decade, when the bursting of the tech bubble and a slowdown in America led many big firms to freeze all technology spending, even when, as with outsourcing, it could cut costs. Now that those firms are over their initial panic and focused on cost reduction, the appeal of outsourcing has soared, especially to low-cost offshore locations such as India. As a result, the export revenues of India's software services market reached $6.2 bn last year, up from under $500 mn in the mid-1990s.

Germany has only itself to blame

It is a general perception that the German economy's undoubted problems are due to the euro. According to this argument, interest rates are too high for the sluggish German economy while being too low for other parts of the eurozone. However, one size always fits all in any monetary area. Real interest rates—the interest rate adjusted for inflation, which is the least controversial measure of the monetary stance—are always higher in slow-growing and hence low-inflation parts of monetary unions. Real interest rates are consistently higher in the North East of England than in the dynamic South East. In Baden-Württemberg, a prosperous and fast-growing area, real interest rates have generally been lower than in other German regions, even with the D-Mark. So pointing out the paradox of inappropriate real interest rates in monetary unions is trite. The issue is empirical. Has the euro in any way aggravated the problem, compared to past monetary arrangements? A recent European Parliament study concluded That both short-term and long-term real interest rates in most eurozone members, including Germany, are at their lowest since 1980.

The German case is particularly interesting because it accounts for a third of total eurozone output and because Germany's inflation rate is currently 1% against a eurozone average of 2.2%. But German short-term real interest rates over the past year have been at their lowest level since 1980 and are substantially below their level in several periods when there was more spare capacity (such as 1980-85).

US accountants in jeopardy

Accountancy firms' lucrative tax advice work was placed in further jeopardy when a powerful US panel urged companies to restrict the tasks they give to outside auditors. The warning came as the panel of influential executives, and academics demanded an overhaul of US corporate governance, including splitting the roles of chairman and chief executive. The Conference Board's commission on public trust, co-chaired by Peter Peterson, founder of the Blackstone Group, and John Snow, the newly-appointed Treasury Secretary, added its voice to calls for corporations to put their house in order after a year of scandals. Some of the work of accounting firms, whose integrity is under fire after a wave of audit failures, is singled out for criticism. They are now banned from much non-audit work at audit clients because of fears of a conflict of interest.

The panel says, "Auditors' development and recommendations of new tax strategies for their clients is not closely related to the audit and, in our opinion, removes focus from their audit work and poses a potential conflict of interest."

It said tax strategies were often accompanied by 'success fees' and "if implemented, were often subject to an audit by the (same) firm. This practice, in our opinion, is highly undesirable". The panel added that auditors should not offer "debatable tax strategies and products that involve income tax shelters and extensive offshore partnerships and affiliates". Its views come at a critical moment for the audit profession.

Wal-Mart to offer cheap financial services

Basic financial services for US customers, using the same low-margin strategy has turned it into the world's biggest retailer. The entry of the discount superstore giant into financial services has always been feared by financial competitors that it could undercut their margins while facing a lighter regulatory burden.

The retailer's move could provide stiff competition to rivals including banks, Western Union, and US Postal Service, which handled 220 million money order transactions in 2000, according to the Nilson Report, a credit card research group. Wal-Mart, based in Bentonville, Arkansas, has twice tried to buy banks in the past three years but was thwarted by changes in state and federal legislation.

An attempt last year to offer banking services up to 100 new stores in partnership with a US subsidiary of Canada's Toronto Dominion Bank ran into regulatory problems. But Wal-Mart, which rents out space to local banks in many stores— says there are services such as cheque cashing, wire transfers and money orders that it can offer without owning a bank. All three have been introduced into at least some stores in recent months, and are now being expanded across the US. Analysts see the move as a possible first step in a broader push into financial products.

N Janardhan Rao

Coca-Cola Femsa in a $3.6 bn deal

Mexico's largest soft drinks bottler, Coca-Cola Femsa, made an expensive choice to become the second-largest Coke bottler in the world by paying $3.6 bn (3.505 bn) to acquire Panamerican Beverages (Panamco). It paid more than double Panamco's market value in hopes of bringing its efficiency and successful strategies to Panamco's sprawling operation. Coca-Cola Femsa will now handle 30% of the parent company's beverage trade in Latin America and 10% of the world volume. Coca-Cola Femsa offered a mix of cash, new shares and assumed debt for Panama-based Panamco, Coke's main bottler with strength in Mexico and Central America, and operations in Venezuela, Colombia and Brazil.

The proposed deal is one of the largest Latin-American cross-border acquisitions and follows Pepsi Bottling Group's launch of a $1.25 bn tender offer in May for Mexico's Pepsi-Gemex, the largest Pepsi bottler outside the US.

Coca-Cola Femsa, in which the US drinks group has a 30% stake, is offering holders of Panamco class A common stock $1.82 bn in cash, or $22 a share—a 118% premium over the stock's close last Friday. Holders of class B stock, which is not listed, will receive $247 mn in cash, or $38 a share. Coca-Cola Femsa is also assuming $880 mn of Panamco's net debt. Coca-Cola Femsa plans to fund the deal with a $2.05 bn bridge loan from the two banks. It would refinance its borrowings with a peso and international bond offering and in the syndicated loan market. Coca-Cola Femsa was advised by Morgan Stanley, and Panamco by JP Morgan.

Mexico, with 100 million people and the highest consumption of cola beverages per head, is the second-largest carbonated soft drinks market after the US. Some 70% of the combined company's earnings will come from Mexico, where it expects to save $70 mn by combining operations. Panamco is receiving a 111% premium over its six-month average share price.

GM sells business unit

General Dynamics, US defense and aerospace group, agreed to buy General Motors' defense unit, which makes light armored vehicles, for $1.1 bn in cash. The deal makes General Dynamics the leader in wheeled armored vehicles, giving the group better scale to produce them more efficiently and an expanded presence in the market for such higher-margin vehicles. The deal, however, excludes GM's military truck business.

General Dynamics makes other vehicles such as tanks, ships, military information technology systems and Gulfstream jets. The combination also gives General Dynamics all the revenues and profits from the new Stryker vehicle, which is part of the US army's plans for more rapidly deployable forces. The GM unit, with an estimated $950 mn in sales and $115 mn in operating earnings this year, was a 50-50 partner sharing sales and profits with General Dynamics in a joint venture to produce Stryker.

Rather than a blockbuster merger to add completely new businesses, the General Dynamics deal shows defense companies consolidating in certain mature product areas where business is stable and profit growth can come from building economies of scale in manufacturing. Products such as satellites, helicopters and armor are seen as areas where such consolidation is likely to continue.

General Dynamics adds a product extension but also gets synergies from being the sole producer of Stryker and GM's other armor, such as the Piranha combat vehicle. Company sources at General Dynamics say that the company does not expect significant antitrust problems from the Pentagon or US regulators due to ample global competition. It expects the deal to close in the first quarter of next year.

Veritas buys Precise Software

Veritas Software, the storage systems group, is all set to acquire Precise Software Solutions for about $537 mn in cash and stock. The deal, valued at $16.50 per Precise share, would add performance measurement and problem solving capabilities to Veritas' service. Veritas would also be buying privately held Jareva Technologies, which makes software that automates administration of server computers, for $62 mn.

Veritas is broadening its capabilities to help beat competition from storage rivals EMC and BMC Software, which are aggressively marketing software products to offset the effects of a price war in storage hardware. Acquisitions such as Precise will help Veritas build the capabilities to manage

storage on computer servers. Precise's software enables users to spot problems with the operation of Web servers, database and storage devices by maintaining a continuous check on these applications.

As per the terms of the deal, Precise shareholders can elect to receive cash for their stock or as much as 25% in Veritas shares. Precise, which is based in Or-Yehuda, Israel, was first traded on US markets in June 2000. California-based Veritas hopes to use Precise's capabilities to provide less downtime and faster operation of software applications, provided by companies such as SAP, Oracle, BEA and Microsoft. The Precise transaction is expected to close in the second quarter of 2003 and is subject to Precise's shareholder approval.

Skandia sells American subsidiary

Skandia is selling its American subsidiary to Prudential Financial as the Swedish insurance and savings group seeks a return to profitability. Skandia has been badly hit by falling equity markets, in particular at its once core US operation, which hit sales of its equity-related savings products.

The $1.15 bn deal with Prudential Financial, one of the largest US insurers, will see Skandia retreat to its European operation, while it will also use the cash to repay debt. Skandia will incur a charge of SKr4.4 bn from the transaction, which will be completed in the second quarter of next year. In the late 1990s, Skandia transformed itself from a traditional composite insurance group into a focused financial services group concentrating on long-term savings. On the back of the stock market boom it was able to boost sales with investors eager to buy equity-related savings products.

Skandia's business model is to act as a wholesaler of savings products, taking fees from both the customer and the fund manager. But, as equity prices have slumped, so has interest in the group's products, especially in the US operation, which had been the driver for growth.

CSFB sells clearing unit

Credit Suisse First Boston is selling its Pershing clearing unit to Bank of New York for $2 bn in a deal that will shore up the finances of the investment bank's parent, Credit Suisse (CS). CS lost SFr2.4 bn ($1.7 bn) in the first nine months of 2002 primarily because of losses at CSFB and at Winterthur, the Swiss insurer it acquired in 1997.

CS has responded by sharply reducing its dividend and looking to sell non-core businesses. Analysts saw Pershing as the only valuable asset that CS could sell without damaging its two core businesses, global investment banking and private banking. The sale will lead to an after-tax loss of $250 mn but it will eliminate $500 mn in goodwill on CS' balance sheet and reduce its risk-weighted assets by $1.8 bn.

CSFB acquired Pershing as part of its $11.5 bn purchase of Donaldson Lufkin & Jenrette in late 2000. Pershing is an industry leader in clearing, which involves making sure stocks are smoothly passed to the right owners. However, CSFB was straining to keep up with the technology spending required in the clearing business. Adding to the pressure was competitive pricing from new entrants and a global economic downturn that have reduced trading volumes.

CSFB officials also feared that technology expenses could keep growing as regulators require banks to improve back-up facilities to avoid the kind of problems that followed the September 11 terrorist attacks in New York.

Bank of New York (BNY) is a power in securities servicing and the Pershing acquisition is a classic attempt to benefit from economies of scale. It would be paying $2 bn in cash and has agreed to a contingent payment of $50 mn based on future performance. As part of the deal, Pershing will repay a $480 mn loan to CSFB.

BNY secured Pershing despite competition from rival firms, including Goldman Sachs and Bear Stearns, as well as Fidelity Investments, the Boston mutual fund company. Merrill Lynch advised BNY while CSFB did not have an outside financial adviser.

US Steel buys National's assets

US Steel is going to buy the assets of National Steel for $950 mn, assuming workers approved a new labor contract. The acquisition, which would make US Steel the fifth largest steel-maker in the world with 25 million tons of annual raw steel-making capacity— follows International Steel Group's $1.5 bn offer for Bethlehem Steel, rescuing it from bankruptcy. The deals could help vindicate President George W Bush's controversial decision last year to slap tariffs of up to 30% on steel imports, needed, he said, to enable the struggling industry to consolidate.

US Steel will assume $200 mn of debt, and is expected to generate annual cost savings of $170 mn within two years from operating synergies and improved labor contracts. It will not assume any legacy costs from previous retirees.

D G Prasuna

The Determinants of Success

During the great depression, the US Government enacted the Banking Act of 1933, commonly known as the Glass-Steagall Act, in an attempt to calm down the fears expressed about the failures of banks. This Act has placed a regulatory burden on the commercial banks by limiting their product array, the prices they could charge and the types of firms whom they can affiliate. In short, it restricted the banking activities. However, this Act has become outdated and untenable with time. With technology innovation, firms were able to create and recreate products and services in different ways that were perhaps envisioned decades ago.

But owing to the regulation, individual firms limited their scope of activity. Commercial banks did not offer the full range of security investment services, investment firms could not offer demand deposits and insurance companies confined themselves to insurance services. While some big firms circumvented the regulation explicitly or implicitly, some firms interpreted the regulation innovatively. The financial services industry has progressed over the decades under the Act where banks were granted greater freedom in product mix, and to form companies that can expand their operations. With the entry of new players like GE Capital and others, numerous financial services firms are operating under different regulatory charters and competing in the broad financial marketplace.

In 1999, the Financial Modernization Act (FMA) was enacted with the purpose of enhancing competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities, firms and other financial service providers. The proponents of FMA argued that the new legislation would herald in a competitive, stable and efficient financial firms, and a better capital market. However, those opposing the law argue that it will result in unfair business practices and less stable capital markets. But, what will be the impact of the changing nature of both market infrastructure and the regulatory regime on the large financial firms? And now that the firms can do everything, what should they do and why should regulators care?

Public policy vs. Firm level effects

The implications of the changing financial environment can be studied from two broad perspectives: The firm level and the public policy level. While the economists focus on the market effects of the new regulatory and technological environment, and the impact on society at large, representatives of firms view market effects as amorphous and of little interest to them and focus on the impact of the changing structure on their competitive positioning. While both the perspectives stand to be appropriate, the effect of convergence of technology and regulatory changes will have profound micro and macro effects on the financial sector. The effects can be complimentary at times and distinctively different sometimes. In a situation where the new environment results in a more competitive industry, the public will be better off with less expensive and abundant financial services. However, this may hit individual firms badly even though it benefits the society. The real value to the economy is brought by the social value delivered by the firms and institutions that collectively make up the industry. The policymakers cannot ignore the impact of change on these institutions and if firms cannot function, the industry will not be in a position to deliver on its role to the economy. Hence, if the social cost of the changes taking place is of a sufficient magnitude, it may require a public policy that could have a severe consequence on the firms.

Effects of financial modernization

In any industry, firms with $5 or $10 bn in assets were deemed to be substantial in the past. But, today the size of the companies have grown so big that we commonly see firms with trillion dollar balance sheet. What is the impact of size on various aspects of business? On various parameters and aspects, the total effect is on improved profit efficiency. Williamson (1985) in the context of financial services industry wrote, it is sometimes stated that when economies are found, they often arise in large specialized firms exploiting a single line of business, not in huge universal banks. The new environment will no doubt, allow American banks to expand into new lines of business. However, if most of the benefits accrue to specialized firms, then, the most commonly argued benefit of multi-product distribution might not be enough to outweigh the costs.

Apart from that bankers argue that universal banks will benefit

Summarized version of the paper "The Determinants of Success in the New Financial Services Environment," by Anthony M Santomero and David L Eckles, The Wharton Financial Institutions Center, The Wharton School, University of Pennsylvania.

from financial modernization as they will be more innovative and in a better position to offer new solutions to customer needs. However, Boot and Thakor (1996) note that financial systems that have always allowed universal banking have not traditionally had an advantage in product innovation. Rather, market dominated systems like the American and British financial sectors tend to be leaders in product innovation. And another advantage that the universal banking can offer is the competitiveness of the banks. It may be true in some product markets where size matters. European institutions have operated historically with the benefit of a universal banking charter. In an increasingly competitive environment, allowing universal banking in the US would place American banks on a level playing field with the European counterparts though the net benefit of universal banking is not fully understood.

However, the issue about stability of large banks still hogs the limelight. Those who favor it argue that these universal banks are more diversified than their specialized counterparts. Steinherr presented an empirical evidence that universal banks achieve a better risk-return trade-off and they have reduced variability of income from lending activity. This research suggests that universal banks are safer and less susceptible to insolvency. Also, due to broadening of the geographic reach and increasing the breath of products and services offered, the firm value may increase. On the contrary, there are at least three reasons that go against universal banking. First, a bad outcome in any one line of business will have a magnified effect on all the lines of the business since the consolidated entity will have both a franchise value and brand name. Second, the usual activity expansion is made under the assumption of relatively uncorrelated business units. However, the correlations are highly positive in all likelihood. Finally, the regulatory environment may sometimes cripple the business activity.

Does one size fit all?

In spite of all the benefits that the universal banking offers to the financial services firms, there are still concerns about the complexity, complacency and fragility of franchises. The general trend towards universal banking seems to be supported by the factors influencing change. Obliviously, there are limits on consolidation which place limits on the mega-bank and its ability to add market share continuously. Withstanding the regulatory challenges some firms became large universal banking firms. They have become large either through acquisition, new entry or alliances.

The strategy is not a simple diversification, but an interest in capitalizing on the specific capabilities across the financial services industry

What will be the resultant structure of the industry? Perhaps, the answer to this question is that there will be a mix of specialized firms and universal firms. There appears no economic force that will lead to a single firm concept and there will always be room for specialized firms. The strategy is not a simple diversification, but an interest in capitalizing on the specific capabilities across the financial services industry. And no doubt, universal firms will gain a majority of the market share but the specialized firms will also enjoy their presence in the niche market with narrow product lines. On the other, universal banks have to be aware of the fact that last time, the regulators were forced to keep the operating units separate. The universal bank model can succeed only if it can address the contagion concerns expressed by various bodies over a period of time.

Implications for public policy

With the growth of the industry, the role of the regulator becomes crucial. In fact, some of the people have suggested that the regulator should have a clear stake in large financial firms since universal banks are susceptible to contagion effects. The major four public policy concerns include systemic stability concerns, concern over an extension of the government safety net to these firms, the impact of consolidation and convergence on the concentration of power and concerns over conflicts of interests and predatory business practices. The main issue is whether the emergence of the universal financial firm exacerbates the stability concerns of regulators.

The regulators are concerned legitimately about the growth of large universal firms and their effect on macroeconomic stability. But the intervention of the regulator has its own problems. Sometimes it can lead to a situation where a distinction is made between large and small firms. This manifests into a non-level playing field in the industry.

The only viable solution to these concerns is competition, which can be brought about by free entry in open markets. It all depends on the access to consumer and small business market, and as long as the players are open to all, there is very little to worry. It is best to think of all financial product markets as global rather than local. The final solution to all the concerns raised about the financial modernization is the assurance of full disclosure and sufficient competition from other service providers to impose market discipline.

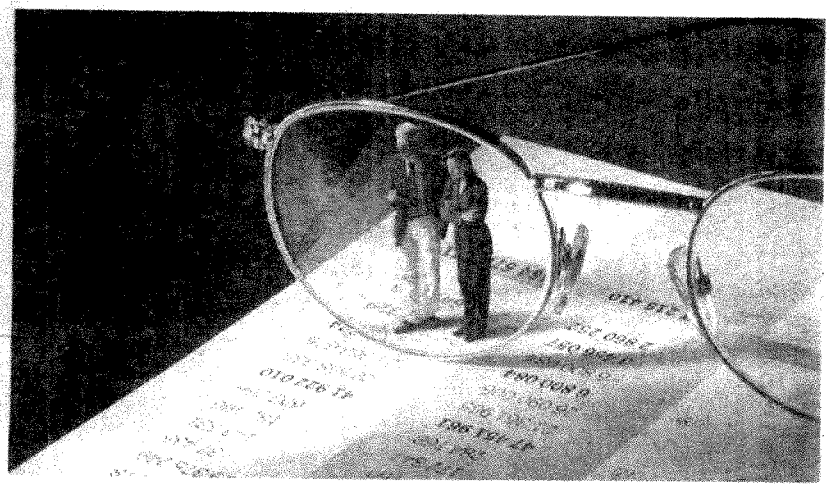
Y Chandra Sekhar

Reference # 1-2003-02-01

CFOs

The new challenges

Series of accounting scandals, economic recessions and integrity issues have raised the risks as never before. Besides, in an era of contraction, reduced expectations and higher market skepticism, the demands on CFOs are unprecedented. Are they geared up to these challenges?



The last decade of the 1990s proved to be one of the most challenging, dynamic periods ever experienced by the Chief Financial Officers (CFOs). It has been a year now, since the meltdown at Enron began. Since then the rhythm of negative headlines has been almost ceaseless, and the corporate miscreants and their misdeeds are so obvious that few financial managers need a recap. Companies like Tyco International, WorldCom Inc., Global Crossing and Qwest Communications International, and the list may go on. In each scandal, the CFOs have turned up in the hot seat.

The days are gone when CFOs were looked upon as financial sorcerors, responsible for reviewing financial reporting and accurately reporting information. Today, CFOs are involved in many more functions than just accounting and financial reporting—companies are relying on them for a lot more. They are being asked to take a new host of responsibilities that require a broad business background with operational experience. They are servicing as financial advisors, key decision makers and visionaries. They are facilitating change, making key technology decision and charting the future of their organizations.

CFOs are being asked to do more than ever before, even as they are brawling with new regulatory mandates like the Sarbanes-Oxley Act. The sudden changes now engulfing business highlight the limitations of traditional financial management systems. Companies increasingly rely on a variety of financing arrangements and struggle to keep up with competing dynamic technological developments. These broad developments pose new challenges for CFOs.

Beyond the numbers

The pressures of an increasingly fast-paced, global business environment, technological innovation, new business structures, changing attitudes towards work and a need to focus on value, are all impacting the way businesses are conducted. In such an environment, the role of the CFO is becoming more critical as the demands made on finance functions change and increase. Finance needs better and faster information, embraces technology and processes to reduce costs and increase efficiency.

Over the years, the strategic importance to a CFO has increased. CFOs have to understand the full extent of their companies' operating business and understand that they are an integral part of a company's top management team.

In the current scenario, the CFO must be a multifaceted visionary who works hand-in-hand with the CEO to achieve the company's vision and enable the long-term success of the company. In today's fiercely competitive environment, filled with M&As, and global competition, the CFO is being forced to shift focus from data gathering and analysis to forward looking business processes and operational strategy.

The emerging role

The financial markets became more transactional and global and more strategic during the early 1980s. New financial instruments, like mortgage-backed securities and other derivative products emerged and CFOs had to be more sophisticated in order to deal with them.

During the 1990s, shifting business models, better financial technology tools—not to mention an investor community that demanded near real-time information on a company's financial status—all forced to evolve the CFO's role, breaking out of the long-held image of a 'bean counter'. "The CFOs consistently

cited the interpretation and delivery of complex information as the greatest challenges facing them and their employers both today and in the future and see these challenges as shaping the future role of the CFO," points out Bill Connell, Director of Risk Management for the BOC Group and Chairman of IFAC's Financial and Management Accounting Committee (FMAC).

He further adds, "As a result of the demands placed on companies by shareholders, regulators and the public at large for increasing financial information, the CFO's role is shifting dramatically from one of transaction manager to communicator and strategist." Management Consultant, McKinsey & Company, believes that a CFO's traditional role as the guardian and leader of good planning and performance management is taking on anew. It is time, the consultancy says, for CFOs to refocus on the basics: Knowing how the company creates value, integrating financial and operational metrics, keeping metrics transparent and uniform, and fostering dialog between business unit managers and their corporate-level counterparts.

With the rapidly changing business environment, CEOs are looking for innovative CFOs who have the ability to think outside the limits

The transformation

Playing a lead role was never traditionally expected of a Chief Financial Officer. They were content with providing back stage support to the CEO and the Board—support in terms of facts and figures to justify and enable decisions on strategic issues. Now they find themselves thrust into a specialist role where their deep technical understanding of finance and the intricacies of the business and financial model enable them to act in an advisory capacity.

The traditional role of the CFO has been that of a controller—a controller responsible for the treasury operations, preparation of financial statements, internal controls, budgetary controls, taxation and internal audit. The traditional view of the CFO as a number crunching official and corporate police officer has changed.

A number of reasons have contributed to this sea-change. Primary among them being the globalization initiatives of corporations and the need to widen access to capital from global investors. T V Mohandas Pai, CFO, Infosys Technologies Ltd. opines, "While protection of assets and capital remains a vital part of their role, CFOs are increasingly being expected to grasp a broader view of a company's operations and play a key role in formulating the strategic directions of the corporation. Today, the CFO has been thrust with the responsibility of shaping the future of his company as a strategic business partner. He is expected to partner with the Board and act as its advisor in creating and enhancing stakeholder value. The emerging role of the CFO is that of an advisor to the CEO and the Board on strategic issues and donning the role of a brand ambassador for the corporation."

The changing equations

The speed of business is changing dramatically, besides an increasingly challenging regulatory environment and rapidly shrinking margins. CFOs must steer their organizations and are expected to be strategic partners with the CEO in guiding the future growth and development of business. CFOs help chief executives establish the value system within a company and provide proper focus on prioritization of business objectives.

CFOs need to be aware of, and evaluate how technology changes are going to impact the business. They need to communicate to the management what those changes are and develop creative ways to address them. They need to be more creative in looking for ways to value their business processes.

"The CFO is expected to identify all risks that could impede an organization's ability to achieve its objectives, monitor and analyze the same with a view to reduce the risk profile of the corporation."

T V Mohandas Pai
Chief Financial Officer
Infosys Technologies Ltd.

With the rapidly changing business environment, CEOs are looking for innovative CFOs who have the ability to think outside the limits. They expect their CFOs to be credentials to the outside world. The CFO needs to protect that credibility, while at the same time support the role and mission of the company.

Financial supermen

Now companies want the CFOs to be almost a 'Super-CFO', contributing a full-time effort on each aspect of the job. The CFO is expected to create shareholder value by delivering on numbers, act as an in-house venture capitalist and challenge business managers to generate value. He is expected to play a key role in strategizing in terms of directing management attention towards business opportunities across the globe and providing fresh and strategic

insights into the business model. It would be apt to mention here that a corporation is a portfolio of businesses and the CFO has a key role in portfolio choices of investing in growth opportunities.

Mohandas Pai concurs, "the complexity of today's business requires the CFO to proactively monitor the various financial and non-financial risks, develop mitigation measures and continuously refine the risk assessment methodologies.

The CFO also needs to communicate to investors the risk management strategy of the corporation. This enables investors to gauge the risk profile of the business and its ability, agility and preparedness to counter eventualities. Investors need to understand clearly the risk to their investment."

The CFOs' role in corporate governance has heightened with the current crisis of confidence in financial markets across the globe

The CFOs' role in corporate governance has heightened with the current crisis of confidence in financial markets across the globe. Accounting scandals, re-stating of reported financials, questionable off-balance sheet transactions and lack of basic corporate governance have led to this crisis.

> **The CFO will become an important partner of the CEO to balance the risk and return dynamics of the company's business strategy.**
>
> **Ramesh Srinivasan**
> *Head, Corporate Finance*
> *Kotak Mahindra Capital Company*

A recent survey among global investors by McKinsey reveals that a majority of investors are prepared to pay a premium for companies exhibiting high governance standards.

The CFO's role is to ensure that the corporation adopts sound accounting policies that lay emphasis on 'substance' rather than 'form' of transactions. He needs to refrain from aggressive interpretation of accounting standards. He needs to drive technology within his group and the organization to build robust information systems that enable him to back his advise to the Board with reliable data and analysis. He needs to facilitate information flows to the audit committee so as to enable audit committee members to discharge their responsibilities, ensure the independence of the information flow and facilitate co-ordination between the internal and statutory auditors.

Mohandas Pai says, "Today the CFO is expected to play the role of brand ambassador of the corporation. The Annual Report and the Web should be used as investor relations tools to enhance the brand image and visibility of the company. He should continuously innovate financial reporting and disclosure policies and the media for investor communication. Transparency is a competitive advantage and the CFO has to use this as a strategic tool to lower the company's cost of capital."

The challenges ahead

The CFO's role in any organization is mostly depended on the nature of the company's business, as well as its size. Smaller companies, for example, don't have the complicated financing schemes or vast array of product and service

> **The CFO is increasingly called upon to be more strategic in his perspective, conserving human capital and is becoming an intrapreneur instead of his traditional introspection role.**
>
> **Dr. Y Subba Reddy**
> *Assistant Professor, Institute for Financial Management and Research*

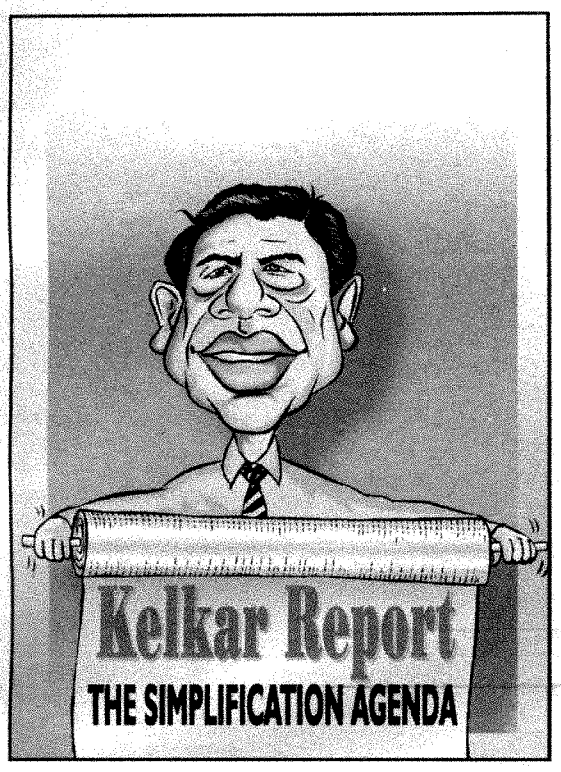
lines that require the same level of accounting virtuosity and strategy prowess. Mohandas Pai concludes that the challenges that today's CFOs need to address are the challenges put forth by globalization of corporations; finding out innovative means of financing; handling regulatory issues globally; handling business ecology issues across the globe; managing currency risks; managing investor expectations; and attracting the best talent.

The rapid changing nature of business world and the resulting paradox in which CFOs find themselves are inescapable. So, as CFOs, they must prepare themselves to meet all the demands that are currently being placed upon them.

The new environment will be challenging and rewarding. Embracing these parameters for a successful career will allow CFOs to play a leading role in making organizations both market-responsive and fiscally sound.

N Janardhan Rao

Reference# 1-2003-02-02



Kelkar Report: The Simplification Agenda

The Kelkar Committee has recommended big bang tax reforms that will make the Indian tax structure more broad-based, revenue buoyant and more equitable. The reforms package emphasizes on self-compliance, nominal tax collection and tax compliance costs and advocacy of taxpayer services. Though the suggestions are broad-based, opposition from certain sections of the population may defer the actual implementation.

Amidst the concerns over the slow global economic growth and Indian economic outlook, the Task Force on Direct Taxes and Indirect Taxes headed by Dr. Vijay Kelkar, has finally submitted its report to the Indian Finance Minister. The academicians hail the report as a path-breaking agenda in the Indian history while the investors, salaried employees, industrialists and politicians describe the report as disastrous. Reports have been published in the media that the implementation of this report, will penalize the salaried class, rob off the lifetime savings of the middle class and destroy India Inc.'s competitive advantage on the global front. Politically, the implementation of the recommendation was termed as a deathblow to the government. But are the fears expressed by the salaried class, investors, industrialists and politicians legitimate? What are the merits and demerits of the proposed changes? And finally, what is the likely impact of the recommendations on the economy?

Need of the century

Indian systems have a reputation of being complex and rigid. The very fact that India attracts the low foreign direct investments among the emerging markets in spite of its liberalized policies highlights the complexity and rigidity of the Indian system though it is not the

only cause. Undoubtedly, taxation is one area where one would not like to interfere. The reluctance on the part of corporates and individuals is just because of its complexity. N R P Parasuraman, Professor of Finance, SDM Institute of Management, stressing on the need for reforms in Indian tax regime, says, "The Indian tax regime has been crying out for reforms for some years now. On the one extreme, we have had severe taxes on certain segments, and on the other considerable avoidance of taxes by certain other segments. Overall, one has not been convinced that the economic objective of allowing tax concessions has been fully met. Further, there has been an overall feeling that the laws and the administrative rules there under have been very complex."

Though there has been a need for reforming the tax regime in India since a decade, successive governments have failed to take the initiative. Opines, Mukesh Agarwal, Managing Partner, Singh Agarwal & Associates, "In fact, the Indian tax regime needed reforms long back and a beginning was made when V P Singh was the finance minister. But due to various political compulsions it could not take proper shape by now." The Income Tax Act 1961 has not been amended much since its enactment. But the conditions have certainly changed. N M Ranka, President, All India Federation of Tax Practitioners, explaining the condition of the Indian tax regime says, "Indian tax regime is in a precarious condition. In spite of fat salaries, perquisites, benefits and facilities, efficiency and expeditious disposal are absent. Records are in a mess. Old records are not traceable. Refunds are abnormally delayed and rectifications and appeal effects have to be reminded again and again. Added to all these woes of the taxpayers, accountability, and transparency is clearly absent in the present set-up." Clearly, the bottlenecks that have developed in the Indian tax regime over the past couple of years have prompted the government to constitute a high level committee that would recommend the necessary changes to be brought about in order to make India a more attractive investment destination.

Also, the role of the government has changed significantly with the liberalization of the Indian economy in 1991. The present income tax laws pertain to an era where the government undertook the onus of economic growth and placed economic enterprises in the government sector. The first generation reforms have transformed the role of the government in the economic growth of India. Opines, Mukesh H Butani, National Director, Global Tax Advisory Services, Ernst & Young, India, "The evolution of the role of the government and its approach to economic growth policy has resulted in a highly complex tax regime marred with multiple exemptions, extensive compliance requirements, high litigation etc. Further, recent years have witnessed lack of buoyancy in tax collections, unsatisfactory state of tax administration, dissatisfied taxpayers and a plethora of such issues." He further explains, "In this backdrop, it was essential to take a fresh look at the tax policy and administration prevailing in the country in light of the globalization process, the role of the government and international precedents."

Though the government has constituted various committees in the past, for the first time, emphasis was placed on reducing complexities of the tax regime. Every individual who is a resident of India is aware of the complexities involved in the entire process, right from tax computation to return filing. There are numerous exemptions, rebates, and different standard deductions to different salary classes that leave a taxpayer

"It was essential to take a fresh look at the tax policy and administration prevailing in the country in light of the globalization process, the role of the government and international precedents."

Mukesh H Butani
National Director
Global Tax Advisory Services
Ernst & Young, India

in a state of confusion. It is a common scenario that people try to work out various permutations and combinations to minimize their tax liability. Often, a taxpayer ends up spending numerous working hours in arriving at his tax liability and planning a tax saving. Commenting on the disadvantages of a complex tax regime, Prof. S Sundararajan, Professor in Finance and Control, IIM, Bangalore, says, "I feel that no one—whether individual or corporate or any other entity—should spend time working on getting around tax, both direct and indirect. This results in waste of precious energy of people, which should have been spent working on other kinds of innovations and not definitely tax. The tax incentives provided drive the assessees to go for tax planning which eventually leads to tax evasion."

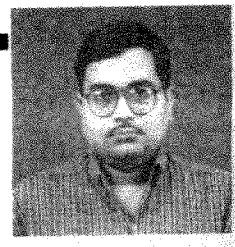
The need to reform the tax regime is not only to reduce the complexity but also to enhance the efficiency of the income tax authorities. Owing to the huge complexities, it takes considerably a long time to process every single tax return application. And this has

resulted in a slow process. If this is the case of individual taxpayers, then one can imagine the assessment of corporates. Exemptions, depreciations, book profits, dividends, technology, patent and trademarks are only a few in the list. All this have complicated the process and the system to such an extent that it is proving to be a biggest hurdle for India in its global integration process. The second-generation reforms have stressed on the need to simplify complex process to boost the economic growth. In fact, the committee has highlighted this fact in its final report when it said, "The government is convinced that rationalizing and simplifying direct tax laws and redesigning procedures to bring them at par with practices of other dynamic economies is *sine qua non*. Accordingly, the Task force was assigned the following Terms of Reference: (i) Rationalization and simplification of the direct taxes with a view to minimize exemptions, remove anomalies and improve equity; (ii) Improvement in taxpayer services so as to reduce compliance cost, impart transparency and facilitate voluntary compliance; (iii) Redesigning procedures for strengthening enforcement so as to improve compliance of direct tax laws; and (iv) Any other matter related to the above points."

Towards the right path

For millions of Indians, the Kelkar Committee is like a bombshell that can literally shatter their dreams. The Task force recommended far-reaching changes in the tax regime emphasizing on bringing in international practices. The committee has strongly advocated introducing big-bang reforms both on the direct taxes and indirect taxes front. Though the salaried classes were the first to express immediate concern on the direct taxes front, industrialists and politicians joined the bandwagon soon. In fact, Bharatiya Janata Party's committee headed by Rajnath Singh termed the recommendations on taxes as "anti-farmer and anti-middle class". Ever since the first draft report was made public, there was a wave of opposition that has crippled the prospects of implementation of the recommendations.

A broad look at the recommendations suggests that the committee has actually emphasized on various factors that has made the tax regime rigid. Right from tax administration to automation of the transactions, the committee has recommended drastic changes. One of the major tasks of the Task force was to correct the existing anomalies in the Indian direct tax system. The approach to reforms was made after a detailed study of various economies that have improved their tax-to-GDP ratio in the recent past. The recommendations aimed at reducing costs of tax administration and improving the efficiency of Central Board of Direct Taxes by transforming the tax regime. The suggestions in toto



"Individual taxpayer will be the ultimate gainer from the two-tier structure. So far as savings are concerned, presently individual taxpayer has been forced to save in a particular way only and not much choice is given."

Mukesh Agarwal
Managing Partner
Singh Agarwal & Associates

Concessions Likely to Go

- **Sec.16(i):** Standard deduction available to employees.
- **Sec. 88:** Tax rebates on investments in specified assets such as NSC, NSS, EPF and PPF, tax saving units of mutual funds, premium paid on life insurance, repayment of housing loans, and infrastructure bonds of IDBI and ICICI.
- **Sec. 80L:** Interest income and dividends from specified sources.
- **Sec. 88B:** The Rs. 15,000 tax rebate to senior citizens. Currently, a senior citizen should have completed 65 years on the last date of the FY.

  Henceforth, senior citizens will be taxpayers who are more than 65 years in age on the first day of the financial year.
- **Sec. 88C:** Tax rebate of Rs. 5,000 to non-senior female citizens.
- **Sec.10(15i):** Income by way of interest, premium on redemption or other payment on notified securities, bonds, annuity certificates, savings certificates, other certificates and deposits issued by the Central Government.
- **Sec.10(15ii-b):** Interest on notified capital investment bonds. Note that no bonds can be notified after first day of June 2002.
- **Sec.10(15ii-c):** Interest on relief bonds.
- **Sec.10(15ii-d):** Interest on notified bonds.
- **Sec.10(15iv-h):** Interest on notified public sector bonds.
- **Sec.10(15iv-i):** Interest on deposits out of money received by an employee on retirement.

Source: www.rediff.com

are not entirely new but are relevant and long overdue.

Butani agrees when he says, "Sensibly, the Task force has recognized that in a country of over a billion population, where the potential taxpayer community is several millions, a complex and enforcement-oriented tax policy and administration is ineffective and inefficient. The shift has to be towards a simple and voluntary compliance environment, and the tax administration needs to evolve a framework (i.e., systems, processes, procedures, infrastructure and mindset) for taxpayer services to enable a high degree of compliance by the population. The recommendations of the Task force are undoubtedly the need of the hour." People who have criticized the recommendations fail to understand the backdrop of the reforms. Justifying the government intentions to go ahead with reforming the tax laws, Parasuraman feels, "While one may not agree with every one of the Kelkar proposals, one has to say that overall reforms seem to be in the right direction. Tax laws have to become less complicated to facilitate the twin purposes of timely collection of dues and clarity of purpose. The reforms have succeeded on this score." In fact, various industry bodies have complimented the efforts of the Task force for suggesting a broad based, more revenue buoyant and more equitable tax structure.

Is the prescription right?

Tax incentives: The suggestions of the Task force have given rise to a storm. The total revamp of the existing laws, if implemented, is poised to radically transform the regime. Out of the major recommendations of the committee, dismantling of exemptions and raising the minimum income level to Rs. 1,00,000 from existing Rs. 50,000 has taken the market by surprise. The rationale behind such a move according to the Task force is to eliminate small accounts which are high cost-ineffective in terms of servicing. But, if the minimum income level is raised, it is feared that about 40% of the existing taxpayers (approximately 80 lakh income taxpayers) will move out of tax bracket. This is believed to result in a steep reduction in the revenue collections. However, the committee feels that the revenue loss can be compensated by the removal of tax rebates/deductions, which are operating under Sections 10, 80 and 88. But considering the present mix of taxpayers, deductions and rebates, except for standard deduction are operated only for a limited number of income tax assessees. Further, the limit may be very high considering the average per capita income of India. Perhaps at a time, when we are contemplating to widen the tax base, the suggestion seems to be indifferent.

The strongest opposition has been received on this recommendation. Majority of the people feel that the tax incentives were provided to the public to encourage savings. In the absence of that, the very purpose of savings may be diluted. Parasuraman feels, "Every economy, which is growing would need a constant influx of savings to book investments and in turn boost growth. One of the ways of encouraging savings would be to dangle the carrot of tax rebates. By withdrawing this incentive, certain segments would find no reason for saving." However, he sounds optimistic about the future when he says, "While in the short run this might boost growth, in the long run the absence of savings might prove a hurdle to growth. One has to realize that this is a deep macroeconomic aspect that needs to be studied with quantitative data and analysis and one might presume that probably the committee has done this."

If this suggestion is implemented then it is feared that

> **"Political will is clearly lacking. Reforms and recommendations are confined to paper always. It is high time that the government takes bold and independent decisions."**
>
> **N M Ranka**
> *President*
> *All India Federation of Tax Practitioners*

instruments like NSC, KVP, bonds offered by institutions like ICICI and IDBI may lose their tax attractiveness and the investments in these securities have to depend on the long-term investment strategy of the investors. A look at the saving pattern indicates that the average household in India, makes a savings decision after opting for those qualifying for exemptions and then at the instruments with the highest interest rate available. This also highlights one important aspect that is by and large ignored by the general public that tax exemptions by themselves cannot lead savings as limits for exemptions are clearly indicated. In fact, the committee has pointed out that by providing tax incentives to these instruments, the investments are being driven by short-term benefit factor rather than long-term benefits. The committee felt that in the absence of incentives, investors will invest in these instruments keeping in view their long-term interests and that can provide the nation with a sustained long-term capital. Though the thinking of the Task force is to improve the capital generation process, it has failed to understand the savings pattern of the Indians.

Two-tier structure: One of the major suggestions of the Task force is to modify the income tax structure from three-tier structure to a two-tier structure where individuals earning less than Rs. 1,00,000 are totally exempted from tax, and individuals earning between Rs. 1,00,000—Rs. 4,00,000 will have to pay a tax @ 20% and above Rs. 4,00,000 the tax rate will be 30%. According to the Task force, this two-tier structure will enable the CBDT to function effectively and the computation of the tax liability becomes easier. Though the general public has not responded against the idea of moving to a two-tier structure, concerns were expressed again about the savings of the individuals. Agreeing with the Task force, Mukesh Agarwal opines, "Individual taxpayer will be the ultimate gainer from the two-tier structure. So far as savings are concerned, presently individual taxpayer has been forced to save in a particular way only and not much choice is given. Everybody has got the tendency of saving but in their own way. So, in my view, saving is not going to be affected in any way as a whole." He also disagrees with the comment that individuals will be paying more tax and will be left out with fewer savings.

Echoing a similar view Butani also feels that the tax liability in the new structure will be less than what is perceived by the general public. He says, "The rationale for the criticism being that the recommendations will lead to a higher tax liability on individual taxpayers. However, the final report presents empirical evidence to the contrary. The report has extrapolated the figures of actual tax liability of taxpayers under the existing regime for tax liabilities under the proposed regime. The conclusions, contrary to general belief are that the tax liabilities actually reduce across all income levels." See Table 1 for differences in tax liability. He concludes, "Accordingly, in such an event (where the entire reform package is implemented), based on the statistics cited, the taxpayer will get a better deal."

Table 1

(Figures in Rs.)

Income range	Existing tax liability	Proposed tax liability	Tax relief
100,000-150,000	8,901	6,334	2,567
150,000-200,000	22,897	15,746	7,151
300,000-400,000	75,600	49,335	26,265
500,000-1,000,000	185,415	140,886	44,528

Housing loans: Another important suggestion that has received criticism is the removal of tax incentives on housing loans. The Task force recommended phasing out the exemptions provided on housing loans in a three-year period, though a minimum exemption is recommended for loans upto Rs. 5 lakhs. Presently, majority of the individuals are availing this exemption in the process of acquiring a house. The recommendations of the Task force did not receive any comments from the housing finance companies so far, but some people have criticized it. According to critics, the suggestion if implemented will lead to a sharp decrease in the demand for housing loans. At present, the housing sector has been growing at a rate of 25% every year and in fact it is one segment that has outperformed other sectors in spite of the sluggish economic growth.

A negative impression has been created that withdrawal of the tax sops on house loans will hit the middle class dream of owning a house. In case, the sops are withdrawn, taxpayer would be paying less tax on account of lower interest rates. In fact, the withdrawal of housing sops would not matter much now, as the interest rates are around 10% only. This would have definitely hit the middle class, if the exemptions were withdrawn at a time when the interest rates are around 16-18%. At that time, the interest liability would be much higher and together with the tax liability this would mean a big financial burden on the individual. At a time when the interest rates are moving downwards, the withdrawal of exemptions does not make much of a difference. For instance, the government provided the incentive support when it realized that the interest rates were moving downwards and disposable incomes went up. This acted as an additional advantage but not as a trigger. However, this exemption may still be continued keeping in view the demand-supply gap in the housing sector and its multiple impact on other core sectors like cement and steel. The removal of exemption should be strongly backed by solid foundation and perhaps a softening of this clause may cheer up the middle class.

Corporate taxes: Compared to the salaried class, corporates have a reason to cheer about the report. On the corporate taxes front also the Task force has attempted equally to simplify the process. At the same time, it has suggested to reduce the corporate tax to 30% from the existing 36.75% and for foreign companies the tax rates to be reduced from 40 to 35%. It has suggested the elimination of Minimum Alternate Tax (MAT) under Section 115JB of the Income Tax Act. It has also suggested the removal of dividend tax. And one major suggestion is the restriction of depreciation allowances under Section 32 of the Income Tax Act to the allowance charged to the profit and loss account. This will eliminate the process of calculating depreciation allowances according to both Companies Act and IT Act.

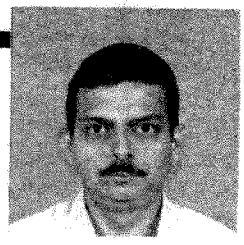
Mukesh summarizes the corporate viewpoint on Task force recommendations when he says, "lesser the exemptions lesser the

compliances and ultimately lesser harassments." Actually, the tax rates are being proposed to be reduced in order to bring the effective tax rate to international standards. Sundararajan exemplifies, "In India we had a regime of high nominal tax rate but a very low effective tax rate. Once I studied the effective tax rate for all sensex companies for a period of 10 years as a proportion of Profit Before Tax. It came to 25% while the nominal rate for this period ranged between 40 and 60%. There were companies with zero or near to zero effective tax rate." In order to bring about a drastic improvement in the effective tax rate the committee has suggested the reduction of tax rates and abolition of MAT. Parasuraman also agrees with the changes being contemplated in corporate taxes when he says, "It has been widely agreed that the rate structure that the Indian companies were subjected to has been very high. Successive governments in the center have not been able to go ahead with initiatives for various reasons. The plethora of exemptions available, though welcomed by a section of the corporate sector, has begun to lose direction of purpose." Elaborating further he says, "The good idea brought out by the Kelkar proposals is that the rates have been reduced and simultaneously the deductions. This may adversely affect certain companies in the short run, but should be welcomed in the overall interest of certainty."

Similar to the individuals, the Task force has recommended the removal of exemptions/deductions and withdrawal of tax holidays for corporates. Commenting on the likely tax burden as a result of these recommendations, Butani feels, "It is likely that the immediate impact of the withdrawal of exemptions/ deductions could cause increased tax cost to those specific companies enjoying tax holidays." The real and overall impact to the wider community however is likely to be positive as stated by Dr. Kelkar "such tax incentives might be rational at the micro-level, but considering the overall higher interest rates structure in India compared to international markets, it might be irrational at the macroeconomic level." According to Butani, "For those where tax holidays currently prevail, the impact will be cushioned in the medium-term for several reasons. These include the introduction of taxpayer services, taxpayer-oriented approach of tax administration, and modern tax administration systems resulting in a significant downward impact on compliance costs of taxpayers."

Though the corporate world has welcomed the proposals of the Task force, in the areas of tax holidays and roll-back of fiscal incentives, there was some opposition. But the Task force emphasized that it is important to view the roll-back of fiscal incentives from a standpoint of aggregate tax costs to the corporates and their shareholders. Butani, supporting the move of the Task force explains, "In the existing regime, while a tax holiday company will not pay tax on its profits, when the profits flow through to its shareholders, they will pay income tax. As a comparison, in accordance with the recommendation, the company will pay tax @ 30% whereas the shareholders will be exempted from tax. Hence the aggregate tax cost on the earnings of the company and of the shareholder will be 30% that is equal or lower than the prevailing tax holiday regime." He concludes by saying, "The taxpayer may be better off under the regime envisaged by the Task force in spite of the roll-back of the fiscal incentives to corporates."

Economic impact: Considering the economic benefits that the simplification can offer, the recommendations are worth



"One of the ways of encouraging savings would be to dangle the carrot of tax rebates. By withdrawing this incentive, certain segments would find no reason for saving."

N R P Parasuraman
Professor of Finance
SDM Institute of Management

implementing. One has to believe that the Task force has done the groundwork to ensure the revenue neutrality, because it is difficult to ensure that individually. Parasuraman quantifies this argument when he says, "The benefits to the economy from the recommendations cannot be easily quantified. The proposals have been made on certain well-meaning assumptions that these would result in increased tax collections, at lower strain. Further, the reduced tax regime is aimed to act as a growth incentive. Also, the report assumes that the negative aspects of withdrawal of incentives on savings would not have any macroeconomic impact that is adverse." He sounds equally optimistic about the future outcome when he says, "Only time can tell whether these will go according to plan. But the proposals need to be commended for being clear about a path and for going about it in a business-like manner."

In spite of the fact that there is opposition for the recommendations from certain classes of taxpayers it is important for the government to go ahead with the implementation as this new structure will enable the growth of the economy in a

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more profound way. Butani feels, "The recommendations if implemented may spur India to ultra modern tax administration system while dispensing with use of tax as a policy tool (via incentives), at the same time beautifully balancing the entire thing so as not to cause additional tax burden to taxpayers." This will nourish a business environment, which will be conducive to the growth of the industries: individual prosperity and more importantly improve the efficiency of the CBDT. Echoing a similar viewpoint, Mukesh calls for the continuation of reforms especially on the tax front. He comments, "Our country has developed a lot in all fronts, if we look at the past 15–20 years, if not more. At present we are in need to get rid of exemptions and deduction for promoting anything. But it has to be in a predefined phased manner like we have reduced various subsidies in the very phased manner. Anything done in a hectic way does not give better results. Reforms are definitely needed on all fronts but in a phased and definite way."

Agriculture Tax: Is it feasible?

One of the surprising suggestion of the Kelkar Committee was to tax the agriculture sector. According to the Task force, agriculture is one area where India lacked to generate tax revenues. Incidentally, this suggestion was made by committee on taxation of agricultural wealth and income headed by Professor K N Raj, nearly three decades ago. The Union Agriculture Minister Ajit Singh along with the ruling party committee on Task force recommendations has strongly criticized the idea of taxing agriculture sector.

Going into the integrities of the suggestion, it appears that the Task force has recommended this move so as to plug the laundering of non-agriculture income as agriculture income. The Task force proposed the states to pass a resolution under Article 252 of the Constitution authorizing the Center to impose a tax on agriculture income. According to the Task force, a number of returns filed in the Mumbai region claimed large incomes from agriculture in areas which are infertile. The revenue losses from laundering were estimated to be around Rs. 1,000 cr from such returns.

Though the suggestion of taxing the agriculture income sounds logic, is it that easy and cost-effective? First, the implementation of this suggestion lies in the keenness of the states to amend the constitution. Considering the political interests, no party will come forward to tax farmers or agriculture income as this segment of population forms the biggest vote bank in India. Then, can the Center do what the states are not willing to do? Here again the power politics come into action. And again, agriculture in India is dependent on the vagrancies of weather and most of the farmlands in India are small pieces of land. The income earned by the farmers on these small pieces of land is very minimum which is barely sufficient to support a family. Under these circumstances, how can the government tax agriculture income?

However, the Task force feels that since 66% of India's workforce is engaged in agriculture which contributes to 25% of GDP, the ratio of average agriculture income to the average non-agriculture income (75% of GDP for 33% of population) is roughly one-sixth. If the same tax exemption ceiling of Rs. 1,00,000 is provided to the farmers also, then only the high net worth farmers will be taxed. Only 5% of the farmers will coming into the tax bracket. But does the CBDT or government possess the necessary infrastructure to tap this sector for garnering tax revenues?

> **"Our tax philosophy has to change drastically (including taxing rich agriculturalists) and from this perspective I feel the approach of Kelkar Committee is in the right direction."**
>
> **Prof. S Sundararajan**
> *Professor in Finance and Control*
> *IIM, Bangalore"*

There is no way that the government can tap this sector without preparing a massive database on the agriculture which includes, agriculturalists, their holdings, cropping patterns in the region etc. This will cost huge infrastructure investment. Actually this very aspect has been the bone of contention between the CBDT officials and the Task force. The Task force has talked about building a national tax information network to facilitate this. However, the political parties feel that such an investment is not worth considering the small revenue that is going to be generated out of this exercise.

Additionally, in a country like India, where the agriculture is vastly spread, it becomes virtually impossible for the government to keep track of things in each region and then compute the tax of each individual. And added to this the complication of assessing the income minus farming expenses. Subject to the passing of the political litmus test, if the recommendation is being implemented, then collection of these taxes from the rural area becomes one of the major issue for IT department.

A cost-benefit analysis of the proposal suggests that the idea though seems logical, it has hurdles at each and every stage of

implementation. And at the end of it, if the revenue generated is less than the effort invested, it may not sound a viable proposition. So, it is important that both the government and the Task force come to an agreement about this issue and weigh the pros and cons of the suggestion.

Still a long way to go

The recommendations of the Task force have reached the Finance Minister's office and they have to go through a fair distance before the actual implementation. Undoubtedly, there are some modifications required to the final report for implementation. In spite of the criticism that the report has been heavily drawn on the Canadian Taxation model, the Task force efforts are laudable. But considering the opposition about the recommendations, their future implementation hangs in doubt.

As soon as the report was submitted, both the Finance Minister and the deputy Prime Minister have brushed aside the report terming it as a consultation paper. Though the final report tried to tone down some of the harsh measures it suggested in the draft report, the political will to implement these recommendations seems to be lacking. Not only from the ruling party but also from all the political parties the report has received criticism. The ruling party under the leadership of Rajnath Singh has rejected the proposals of the Task force. Though the central cabinet has not yet decided on the fate of the recommendations, perhaps the political voice will be echoed in it. Butani commenting on the biggest hurdle in the process of implementation says, "The most significant challenge to the implementation of the recommendations of the Kelkar Committee is the political opposition within the ruling coalition and outside. This is already coming to fore by the group under Rajnath Singh. However, if the necessary will is demonstrated, the recommendations are possible to be implemented, although change will be experienced in the medium to long-term, as creation of the right mindset, technological capabilities and environs of trust and compliance will take time."

But is the political environment conducive to the implementation of such broad and far-reaching reforms? Perhaps the answer is no. Only a few suggestions that might help the political parties in improving their image may be accepted and implemented. The Task force has been sensible in seeing such a danger and it has requested the government that the entire package has to be implemented and the effectiveness of the recommendations will be lost if it is implemented in a piece-meal manner. Appreciating the directional change in Indian taxation, Sundararajan says, "Our tax philosophy has to change drastically (including taxing rich agriculturalists) and from this perspective I feel the approach of Kelkar Committee is in the right direction." If the recommendations are accepted fully then it is important for the government to implement it in a phased manner such that the desired outcome is obtained. Warning against implementation at a single go, Mukesh feels, "No reform shall work if implemented at one go and that too involving a great number of changes in the system also. It has to be in phases so that not only departments but also taxpayers can adopt the same and respond in a positive manner."

The Task force has completed its job successfully by recommending a set of suggestions that really transform the tax regime in India. The onus is now on the government both at the state and central level. Since most of the provisions on the indirect taxes front involve the active participation of the state government, the political clout is going to determine the future of the recommendations. If the government keeps upright its political interests, then there is no doubt that the recommendations will find its place in a dustbin. Ranka sounds pessimistic about the implementation when he says, "political will is clearly lacking. Reforms and recommendations are confined to paper always. It is high time that the government takes bold and independent decisions."

Along with the political hurdles it has some bottlenecks. According to Parasuraman, "The hurdles to tax reforms are substantive and procedural. The Kelkar recommendations have made a good beginning at addressing the substantive issues. By aiming to rationalize the tax structure a lot of clarity has been achieved. On the procedural front, however, a lot needs to be done. This includes speeding up the assessment process, reducing the delay in disposal of appeals and a good mechanism for effective tax recovery in concluded cases. The procedural mechanism is also important from the angle of instilling confidence in the common man that the system is working well."

To a large extent, the objective of the Task force is fulfilled in terms of suggesting a clear reform path. Now, it is for the government to decide whether to implement the suggestions or not. In all likelihood, this report will form the basis for the preparation of Union Budget 2003-04. Some of the recommendations may find a place in the budget and the others may eventually be implemented in the subsequent budget. After all, the report has aimed at simplifying the tax structure, improve tax administration and a better utilization of technology. Since, the complex regimes have always led to Indian economic growth, it is high time that the government amends its ways and takes initiatives to make India a global economic power.

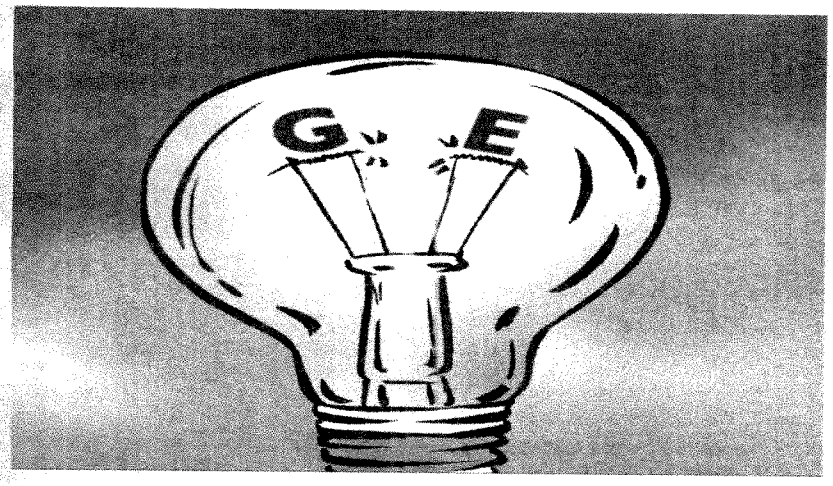
Y Chandra Sekhar

Reference # 1-2003-02-03

GENERAL ELECTRIC

Curse of bigness

Has GE juggernaut run its course? A tepid business environment in some of its key business areas, and the market's growing concern over its accounting practices make the company vulnerable to the increasing pressure of breaking it. The engineering behemoth thus faces an uphill task of not just retaining its size but sustaining its growth as well.



No other company faces the challenges ahead with the size, strength and staying power of GE.
Jeffrey Immelt, CEO

Being big was never a problem for General Electric. The venerable conglomerate since 1993 churned out double-digit earnings growth quarter after quarter, without a break, for nine straight years! Surely a rate and consistency that even a start-up company can envy of maintaining. Indeed, GE managed to deliver such a robust performance unhindered for long. However, more than ever in its recent history, the conglomerate is now up against a horde of odds. That the bad times might be beckoning on the company when the top management was recently forced to lower the company's earnings guidance for the fiscal year 2002-03, admitting weaker prospects in some of its key businesses like plastics and aerospace. Of late, the company has also been dogged by persistent problems in its reinsurance business.

The company founded by the legendary Thomas Alva Edison, the inventor of light bulb, and led till recently by Jack Welch, one of the world's most admired Chief Executives in contemporary times, is facing an uphill task of managing its growth amid a weak economy and the growing pressure of breaking the company.

Hard times beckon

Has the GE juggernaut run its course? Not yet, perhaps. The company has still been able to extract double-digit growth from most of its core businesses, be it financial services, industrial products, or media. However, it is also true that businesses like reinsurance, power systems and plastics are struggling at the moment. In fact, recently the company publicly admitted problems related to its reinsurance business. "Reinsurance is an industry that has had a difficult time over the past few years, and we're disappointed in our results," said Immelt in a company's press release. "We are committed to running Employers Reinsurance Corporation (ERC) effectively for our investors. This includes profitability and exploring strategic options," he added further. The company has said that the ERC business is set to report a fourth-quarter loss of $1.6 bn, much wider than the previous forecast of $150 mn loss. For the year, GE expects the reinsurance unit to post a $1.8 bn loss, compared with previous forecasts for a $450mn loss. "ERC doesn't really fit the GE that I want to have," Immelt admitted in a recent meeting with analysts. The new CEO was particularly concerned about the low return on equity and problems of too many commodity segments, which make business too complex to deal with.

Further, the company's exposure to airlines industry has of late become a major cause of concern. Given the current troubles in the airlines industry, which saw two major airlines namely US Airways and United Airlines going bankrupt quite recently, GE's aerospace business could probably face tough times ahead. This apart, the company's exposure to cyclical business like plastics also raises concern.

The ongoing weaknesses witnessed in some of its key business segments such as reinsurance and power systems management is forcing the top management to reposition the company by shifting away from less profitable businesses and focus more on services and solutions that support medical & retail systems, and airline services. The weakness was reflected in the company's earnings guidance where it said

that 2003 earnings will be hurt by non-recurring gains and option expenses; besides the company has decided to account for stock options costs in its balance sheet, which could have significant impact on its profitability.

Given the kind of weakness the company is experiencing in some of its key business areas, it is difficult to believe that the company's strategy of growing through acquisitions and diversifications would continue to deliver. Moreover, the company faces the dual challenge of lower power system orders and a likely hiatus in jet production. Together, the power and jet divisions accounted for about one-fourth of the company's sales in the last fiscal. The customers of both divisions have fallen on hard times. Earlier this year, for example, struggling independent power generator Calpine canceled $1.2 bn of turbine orders while delaying orders for others. Many market analysts say that without revenue growth from the company's power systems unit, there would have been no growth. They say that unless its other businesses recoup and make up for the power systems decline, sustaining the growth momentum would be quite difficult for the company. However, Richard Wayman, President, Research Stock, USA, says, "My bigger concern is their aircraft exposure." GE's aircraft engine and services business suffered from an industry-wide downturn in business since September 11, 2001. The CEO of the division David Calhoun recently said that with 20% of the US commercial fleet in or near bankruptcy through 2004, the company is shifting to smaller regional and low-cost carriers, which are gaining share. The company's top management has been putting up a brave front by setting aside all growth concerns. It has expressed hopes that GE's businesses supporting the airline industry will see positive earnings growth next year. The company has further said that Power Systems earnings from gas turbine sales will decline as anticipated after several years of exceptional growth; however, the rest of Power Systems, particularly its services, oil and gas, and wind businesses, will deliver strong performances and provide a solid platform for future earnings growth. Not withstanding such optimism, analysts say that weak prospects in some key businesses would make double-digit earnings growth tougher to come by in the near future. At the time of publishing this report GE announced its fourth quarter results for Fiscal 2002, wherein it admitted that rising oil prices could be a key concern as it could further lead to rise in raw materials for plastics division.

Summary of Operating Segments
General Electric Company and Consolidated Affiliates
(Dollars in millions)

	Fourth Quarter		
	2002	2001	V%
Aircraft Engines	561	555	1
Total Commercial Finance	855	660	30
Total Consumer Finance	401	348	15
Consumer Products			
Appliances	122	128	(5)
Lighting	17	75	(77)
Total Consumer Products	139	203	(32)
Industrial Products and Systems			
Industrial Systems	132	110	20
Transportation	134	120	12
Materials			
Plastics	137	215	(36)
NBC	470	412	14
Power Systems	1,375	1,628	(16)

*V% = Change %

Source: General Electric

Many market analysts say that without revenue growth from the GE's power systems unit, there would have been no growth

Growth numbers – Hype or reality?

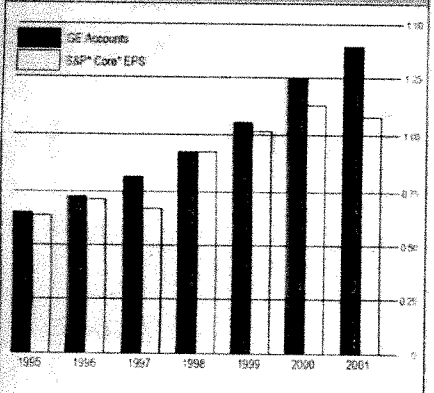
We manage our businesses, we don't manage earnings.

Gary Sheffer
GE

However, allegations have of late poured in from several quarters raising concerns about the company's accounting practices. Recently, Bill Gross an influential bond fund manager on Wall Street, criticized GE for fudging its numbers and poor disclosures. Gross blamed that General Electric runs a smorgasbord of divisions, most of which seem like they should be incredibly susceptible to the economy. He said that company's exposure to extremely diverse businesses like aircraft engines, power systems, media, manufacturing, technical products, services and appliances, and financial services arm, all of this add up to a company whose earnings seem like they should be a lot more cyclical than GE's stated results.

Though GE has on many occasions denied criticism of its accounting practices, the fact is that it needs to explain things. The company has been consistently using non-recurring items like one-time charges and then setting any one-time gain (that too has been a regular feature of the company's balance sheet over the years) against such charges has made even market analysts including fund managers finding it difficult to understand the strategy. The fact is that the company's balance sheet is full of restructuring charges, one-time special gains, and sales and acquisitions. This makes it almost impossible to understand the

The Gap Widens: GE's Core vs. Reported EPS



Source: Standard & Poor's

impact of such charges on a particular business. In fact, many market analysts are particularly suspicious of GE's record of using unique gains and restructuring charges to offset each other without disrupting that quarterly earnings flow. For instance, most recently, charges associated with shutting down the Montgomery Ward chain, which was owned by GE Capital, were offset by a one-time gain from the sale of the last of the firm's stake in Paine Webber. Had these events occurred further apart, they would have ultimately balanced out the same way, but they could have created either a dip in earnings growth or a spike that would have been hard to top the next earnings season. And it does seem curious that GE's many one-time gains, acquisitions, and special charges invariably and smoothly balance each other every three months.

Another significant allegation has been that the company is using income from non-core operations such as pension plans to boost its earnings quarter after. This number has nothing to do with GE's actual businesses, however, it helps the company meet its aggressive revenue-growth targets each quarter. Core Earnings Framework, a valuation model, developed by Standard & Poor, a credit rating agency, aptly explains how GE and other US companies have been using non-core incomes to inflate their earnings (see graph: The Gap Widens). According to its estimates, after removing the impact of 'non-core' profit items such as gains on pension-fund assets, GE's core profits grew by only 9.2% a year during 1995-2001. Going by the rating firm's evaluation metrics, GE might not have achieved the double-digit growth rate during the last nine years at all. In fact, according to some estimates, the company booked handsome gains from its pension funds in the 1990s. During 2001-02, pension-related gains totaled more than $2 bn or 15% of the company's total reported profits. However, it would be a matter of the past with accounting norms getting stricter in future and investors becoming more demanding of the company's disclosure practices.

Breaking GE

Would breaking GE Capital eventually lead to breaking the engineering conglomerate? The recent move by the company to break GE, its financial services business, into four separate units, has given further momentum to that speculation. But most importantly what would this move mean? The company says that this would give CEO Jeffrey Immelt more involvement in its biggest business. With effect from August 1, 2002, GE Capital, which accounts for about 40% of the manufacturer's earnings, will split into separate units handling commerce, consumer, insurance and equipment businesses and each one of them will be assigned different leverage. Each business will report directly to Immelt and GE Vice-Chairman Dennis Dammerman. Immelt says that the reason for doing this is simple—"I want more direct contact with the financial services teams."

The move by the company is also seen as a response by the management to the growing concerns of investors about big businesses and their labyrinth balance sheets, in the aftermath of a series of corporate scandals in America. Analysts say that the move to break up GE Capital is at least partially an effort to make its biggest business more transparent. GE management says that this will create a clearer line of sight on how the company's financial services businesses will operate and enhance growth. In Immelt words, "Our external reporting will mirror this organizational structure, providing greater clarity for investors." But breaking GE Capital would not address all the concerns including the long-term growth of the company. How about breaking the giant then? Given the prolonged recession and changing business landscape, wouldn't it be a sensible move to break GE? "No because you'd still have to deal with the economic factors," says Wayman. Clarifying the company's stance on the issue David Frail, the spokesperson for GE says, "Frankly, the question is a complete overreaction to a challenging economy. GE's businesses complement one another—even the statistical models used by our Aircraft Engines and Power Systems businesses to predict maintenance requirements have been adapted by our financial services businesses to model loan performance. The portfolio is in itself a unique strength of GE." However, maintaining the *status quo* is not going to help the growth juggernaut to continue to roll on the back of a strength of 300,000 employees and annual sales of $125 bn.

> **"Frankly, the question (of breaking GE) is a complete overreaction to a challenging economy. GE's businesses complement one another.**
>
> **David Frail**
> *Media Relations, GE*

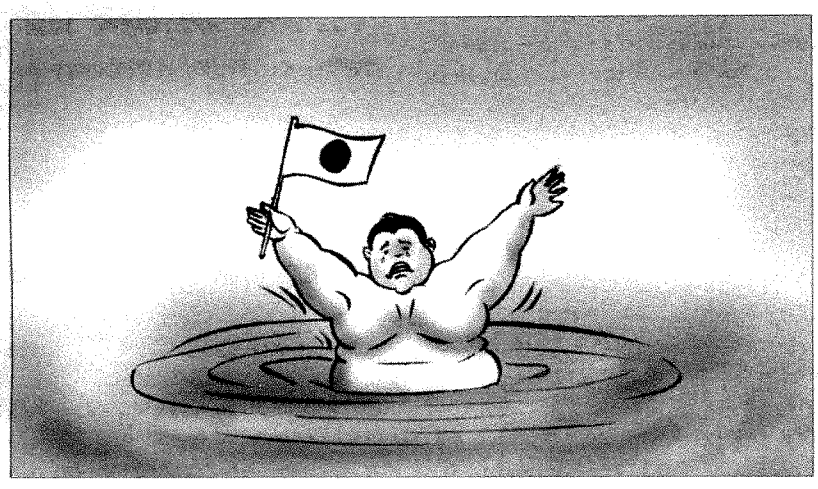
Amit Singh Sisodiya

Reference # 1-2003-02-04

JAPANESE ECONOMY

Recovery in sight?

The world's second largest economy, after 40 years of miraculous economic growth since World War II, abruptly faltered in 1990 and has stagnated since then with no real recovery in sight.



In the late 1980s, the value of emperor's palace in central Tokyo exceeded that of the state of California. This was the height of the real estate market. No one then ever thought that something was fundamentally wrong, and that it can be an equivalent of Tulip mania. At the same time Japanese argued that rising stock prices compensate for the loss of dividends. But what happens if the stock market goes down? The Japanese didn't have an answer to this question since they thought they would never have to answer it. Much of Japan's economic sickness is the after-effect of its bubble in the 1980s—the direct consequence of the speculative bubble in the stock market and real estate market. The Nikkei Average tripled in value between 1985, to its peak at the end of 1989. Real estate values in the six largest urban areas of Japan also tripled between 1985, to a peak in 1991. Since 1985, the stock market and the urban real estate markets have lost all of the gains and the stock market is now trading at a 19-year low. For any economy, such a rise and collapse of asset values of this magnitude would lead to serious economic problems. "It was the collapse in land prices in Japan, more than the collapse in equity prices that really disabled the banking system here. When Japan's hyper-inflated land prices tanked, overextended banks that had accepted property as collateral found themselves in deep trouble. Japanese stocks still haven't recovered and banks' bad debt problems continue to mount," says Mathew Poggi, economist at Lehman Brothers in Tokyo.

The collapse in stock and real-estate prices caused a fall in demand and rise in unemployment. Consumers and firms cut back, and the economy slipped into recession. Bankruptcies spread, demand and employment fell further, and prices and wages began to actually fall. The downward spiral continued as banks called in loans collateralized by the stocks and real estate now worth a fraction of their former value. And the Japanese Government found itself virtually powerless. Even as the Bank of Japan cut interest rates to stimulate the economy, the deflation was increasing the real cost of borrowing and investing. (A 1% nominal interest rate is a 3% real interest rate if prices are falling 2%.) When nominal interest rates hit nearly zero, the economy found itself in a classic 'liquidity trap', in which high real rates and stagnant growth continue to discourage investment and spending, and the Central Bank couldn't reduce nominal rates further to do anything about it. That left Japan in a spiral of rising debt and stagnation.

Real GDP during the 1990s stagnated, rising from ¥428,826 bn in 1990 to ¥469,480 bn by the end of 2000. Since 1992, Japan has grown at a real average of 0.9% annually—normally the long-term sustainable growth rate for an economy of Japan's size is around 3%. The unemployment rate rose from 2.1% in 1991 to 4.7% at the end of 2000. Although the unemployment rate may seem low by international standards, the rise to 4.7% is significant in Japan, given the cultural and historical precedent of lifetime employment and it was never above 2.8% in the 1980s. Over the past 10 years, per capita income in Japan has gone down by more than 10% relative to Europe and by much more than that relative to the United States. Throughout the last decade, the economy has simply continued its slow-motion swan dive.

Japanese governments have been struggling for more than a decade, putting out stimulus, reflation and banking clean-up packages to little avail. Overall, during the 1990s, Japan tried 10 fiscal stimulus packages totaling more than ¥100 tn, and all this failed to cure the recession. What

the spending programs have done, however, is put Japan's Government in poor fiscal shape. The government spending has caused public debt to reach 140% of GDP (highest in the G7). Experts reckon that the government would have to cut spending and raise taxes by a combined 8% of GDP every year just to stabilize its finances. The fancy to blanket the countryside with roads, dams and bridges is often cited as one of the main indictments of Japan's political system. Of course, whether spending on more productive items would have made a difference is debatable. The Central Bank has tried to reinflate, which has only further distorted the interest-rate price signals, slowing the market's ability to correct itself. Despite the massive interest-rate cuts, broader monetary aggregates have not responded because of the poor condition of the Japanese banking industry.

Deflation and bad debts

In spite of the falling prices caused by faster productivity growth, on lines of what happened in the late 19th century will lead to robust growth. Falling prices are particularly harmful when an economy is awash with debt. The falling prices in Japan reflects a slump in demand and excess capacity; it is dangerous, as it was in the 1930s, triggering a downward spiral of demand and prices. Six years of falling prices have produced a downward spiral. This unleashed a vicious spiral of falling incomes, asset prices and rising real debt. Unable to increase prices to boost profits, firms have to cut costs, either by reducing labor costs (and hence household income) or by buying less from other firms. This is sensible for an individual firm, but overall it reduces demand in the economy, thwarting the desired improvement in profit, leading to another round of cuts and putting further downward pressure on prices.

The Central Bank has tried to reinflate, which has only further distorted the interest-rate price signals, slowing the market's ability to correct itself

Japanese banks' bad loans are officially reckoned to be ¥43 tn ($345 bn), equivalent to 8% of GDP, though more realistic estimates put it at twice or even three times that. In the early years of Japan's slump, most banks' bad loans were from companies which had gone overboard during the 1980s bubble with property and other trophy projects that would never make a return. But now, there are hundreds of good companies whose businesses, which might be viable otherwise, have become untenable with prices and demand spiraling downwards. With the Bank of Japan sticking to traditional monetary tool, and weak banks preventing those tools from doing any good, with zombie companies (ones with little or no prospect of ever becoming viable again and causing bad loans) still floundering about, all fiscal stimulus that Japan tried have had little effect, especially the tax-cut measures announced every now and then.

The new man, Heizo Takenaka, an academic who adds the Financial Affairs post to his existing job of Economy Minister, critical of his predecessor, is willing to use public funds to help banks offload their bad loans, which may amount to as much as ¥150 tn ($1.2 tn). Incidentally that was pretty much what his predecessor, Yanagisawa attempted during his first stint as Financial Affairs Minister in 1998 but failed. Four years on, the banks are in worse shape than ever.

How can Takenaka avoid the same fate and deliver on a promise to make banks healthy by March 2005?

The prospect of funds being taken from the public purse could quickly push down government-bond prices, damaging banks' big bond portfolios. Stock markets might also fall, denting banks' equity holdings further. Banks do not want to be branded as weak. A crunchier approach is to lay down tight rules for evaluating loans, and insisting on realistic provisioning for them. That would entail the bankruptcy of many borrowers, particularly in construction and retailing, and big losses at banks. Some banks would have to be nationalized and their managers booted out. Once returned to health, they could be privatized again. Encouragingly, the top brass in government favors this radical approach. Such 'shock therapy' would lead rapidly to the bankruptcy of thousands of unprofitable companies and the destruction of millions of jobs.

> **"When Japan's hyper-inflated land prices tanked, overextended banks that had accepted property as collateral found themselves in deep trouble. Japanese stocks still haven't recovered and banks' bad debt problems continue to mount."**
>
> **Mathew Poggi**
> *Economist*
> *Lehman Brothers, Tokyo*

Prime Minister Junichiro Koizumi took office in 2001, pledging to carry out far-reaching economic restructuring, later on backed off and resorted to the pump-priming measures of his predecessors. The latest package, targeted at twin problems that caused Japan's malaise to persist for so long: Deflation and bad debts in the banking system. However, Takenaka, Economy Minister, under fierce opposition from the bankers, bureaucrats and politicians who

invariably conspired to resist reform in Japan, deferred hopes as nothing substantial came out. The basic concern about the package is that it will not lead to much fiscal expansion; it will probably not prod the Bank of Japan with a sufficiently bold monetary stimulus; it will not take the pressure off well-run companies; and it will not repair the broken banks and zombie companies will continue to haunt both the balance sheets of companies and their healthy competitors. As it is unlikely that there will be any fresh loan write-offs, this plan simply provides another lifeline for firms that are already undercutting healthier rivals. The government has bailed out plenty of unworthy firms in the past.

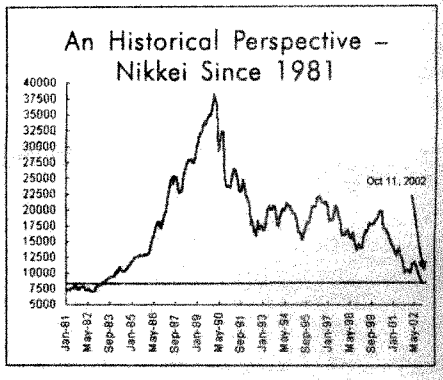
Narrowing options

The world is still awash with excess capacity in industries from telecoms and cars to airlines and banking. Hence, Japan will be unable to export itself out of its problems. With demand from America and elsewhere likely to remain weak for the immediate future, it will leave export-driven Japan dependent on its feeble domestic economy.

Cleaning up bad loans risk dealing a hammer-blow to an economy that is already dormant and deflating. But recovery techniques are narrowing. With clear signs of sagging investments the economy is feared to be heading for another contraction. Such weakness makes it more crucial for any clean-up backed by other economic policies—monetary, fiscal and structural—to keep confidence, consumption and capital spending from collapsing. Although there is no lack of ideas for economic reform, there is a dearth of plans to overcome vested interests. The prime minister and his new 'tsar', Economy Minister, Heizo Takenaka must find a way to spend money that benefits the whole economy, not just the public-works lobby. This will help to offset the lay-offs and bankruptcies that are likely if the government gets tougher on bad loans. Without careful government co-ordination, any such action could be dangerous. Further the economy is worsening. The worsening economy means debts are accumulating faster than banks can write them down, says Poggi.

Tokyo's apparent prosperity makes it hard to convince authorities of the urgency of ushering in change. And without that sense of crisis, reformers have an uphill battle in pushing painful reforms. With the global economy sputtering, and world stock markets periodically threatening to go into a meltdown, any banking plan that forces more bankruptcies and unemployment will be hard to implement. As long as banks refuse to come to grips with their problems, they keep deadbeat corporate borrowers alive and healthier rivals can't get the funding they need to grow. This keeps millions of people and trillions of dollars locked up in the limbo of loan collateral and dries up new bank lending that might otherwise go to more productive uses. Moreover, with interest rates close to zero, even the most irredeemably indebted companies have been able to continue making payments on their loans, scraping the money together by cutting their workforces and forgoing investments. Those weak companies are undermining revenues at stronger companies and putting their survival at stake. Deflationary pressure has also discouraged healthier firms from investing, hence few of them wished to borrow even at near-zero interest rates. With no strong borrowers to lend to, the banks are finding it even harder to earn profits with which to write-off their bad loans.

Unlike countries such as neighboring South Korea, which responded to its crisis five years ago by promptly cleaning up its banks, Japan's massive trade surpluses and domestic savings allow it to continue to postpone action, even as it stores up trouble for the future. To some extent, therefore, Japan's economy is trapped, as the symptoms of its long slide have become self-reinforcing. Poggi, criticizing Japanese policy says,



"The new policy adds nothing to the ones previously declared. It just indicates government has a slow-go approach until a financial crisis actually happens. It just has to take bolder initiatives and the tried, tested and failed traditional measures can do little good."

In America, flexible and competitive markets force firms to cut excess capacity and labor more quickly and restore profits. In contrast, Japanese firms have been slow to cut excess capacity, thanks to a raft of structural rigidities. In Japan, government subsidies and interest rates at zero have kept inefficient firms afloat and so delayed restructuring whereas American firms are under greater market discipline. A cocktail of debt and deflation has left Japanese banks crippled by bad loans, forcing them to cut lending.

According to Poggi, "The main obstacle to Japanese recovery right now is not the long list of structural difficulties but a simple lack of clear thinking and courage." Technically the cures are not hard to implement. The bad news is that what must be done involves some painful economic restructuring. Debts must be written off and the losses allocated to someone. Companies and banks have to be closed down. Unprofitable divisions have to be sold. Managers and workers must lose their jobs. In an economic clean-up after a financial collapse, it must rain on the just and the unjust alike.

Yet as Marx reminds: History repeats itself first as tragedy, then as farce.

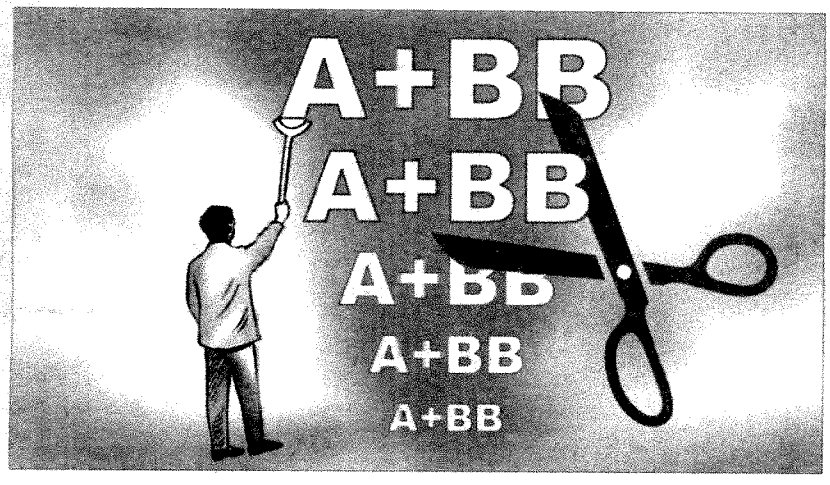
A Sowdeepti

Reference # 1-2003-02-05

ABB

The giant stumbles

The engineering giant is in a deep mess. The Swiss-Swedish conglomerate, which was once Europe's answer to GE, is facing a horde of challenges; prominent among them is to make itself steady.



There were significant divestitures during the last two or three years. By the way, what happened to all the money? Where did it go?

Jüergen Dormann, Chairman and CEO, ABB

For Jüergen Dormann, the man in the hot seat at ABB, the answers have been tough to come by. In recent times, allegations have come thick and fast, doing a great deal of damage to the company's once impeccable credentials. Among the most serious revelations is the award of severance of pay packages to two of its ex-CEOs, including the high profile Percy Barnevik, without the Board's knowledge! But the story does not end here. During an internal auditing, to its dismay the company discovered that its UK subsidiary's accounting numbers for the years 1999 and 2000 were fudged. As a result, it had to record an additional cost of about $25 mn relating to these activities. The company in its SEC filing revealed that, had it not discovered these activities, its net income for 1999 and 2000 would have been overstated by $30 mn and $10 mn respectively. But the bigger challenge the company is facing is to meet the ever-burgeoning liabilities related to asbestos claims at its US subsidiary, which is posing a threat to cause severe damage to the company's financial stability. Exit of several key executives in recent times has added to the growing woes of the company.

No doubt, these issues pose a serious challenge to the company, which for long, boasted of a multi-domestic identity and celebrated the idea of being local worldwide. The impact of the threats can be seen on the company's much-touted matrix structure, which has been losing its stitches all along.

Blame it on Barnevik

It's a sheer irony that Percy Barnevik, the man who nurtured and shaped ABB into a global engineering powerhouse is now blamed for the financial mess which the company is facing. It was Barnevik who masterminded Europe's most successful transatlantic mergers by bringing Swedish Asea, where he was the CEO, and the Swiss Brown Boveri together in 1988. During his reign, between 1988-96, as the CEO of the merged entity, ABB scaled to greater heights of success. During this period, the company's annual revenues almost doubled to $34.7 bn, while its net profit tripled to $1.2 bn. The company's share price too grew by an average of 23% annually. Barnevik's leadership was hailed as exemplary by his peers not only in Europe but also in other parts of the world. He was voted as the best CEO in Europe four times in a row and admired in America too. In fact, he was even touted as Europe's answer to Jack Welch, GE's high profile CEO. ABB's highly proclaimed 'Matrix' structure was a subject of case study in top B-schools in both Europe and America, though many market analysts found it a complex structure to follow. It was Barnevik who gave the company its identity of being local worldwide, meaning the company possessed multi-domesticity. During Barnevik's reign, ABB emerged as a truly global company with operations in over 100 countries and with 1000 separate units. Managing those units was not an easy task but Barnevik ensured that he remained attached to the orbit by flying around the globe to rally the ABB army of managers.

All was well until, the news about his off-the-book compensation deal with the company broke out on February 13, this year. The revelation was made by one of the directors of the company, Martin Ebner, who had raided several companies in

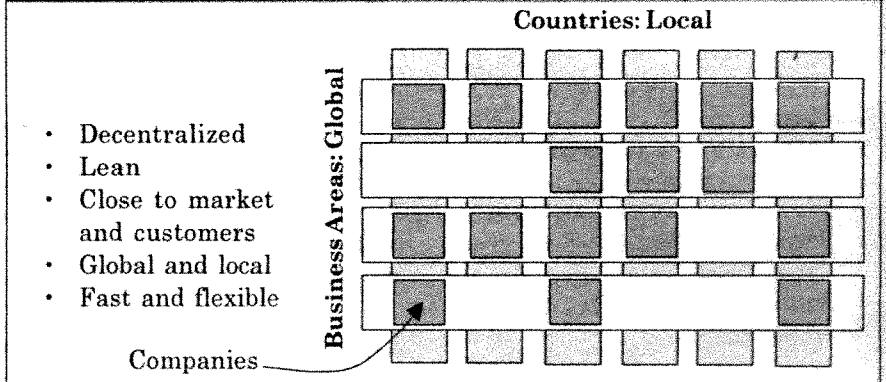
Switzerland and who gained notoriety for bringing poor performing companies to task (his list includes big names like Swiss Air, UBS, CSFB, and Swiss Life); though he too suffered miserably as his investments in these dark horses turned sour and resigned from the ABB's Board very recently.

The nasty disclosure created furore in the marketplace that has become skeptical in the aftermath of Enron's disgraceful collapse. The company's stock crashed by 7% after the company's Board of Directors admitted that approval procedures for those benefits were unsatisfactory and it would press Barnevik to pay back a portion of the pension benefits he had received after his resignation as CEO in 1996; though he stayed on as Chairman until 2001 (he resigned as ABB's Chairman in the autumn of 2001 owning the responsibility for the company's poor performance).

After Barnevik's departure, the structural and managerial flaws, which were wrapped under a high-flying stock price and probably to some extent on dodgy accounting, became evident. Many now blame him for the growing fissures in the organizational structure. Researchers say that it is uncertain whether ABB and its followers are creating local autonomy within the framework of a giant corporation. They suggest that ABB's modern central management techniques of coercive comparison (benchmarking), in fact, may limit the scope of action of local managers and workers much more effectively than an executive of a traditional hierarchically organized company. It has been observed that often, central executives of hierarchically organized companies lack the material capacity to enforce their will against the joint opposition of local management and labor; citing the rift between the German subsidiary (protected by the local government) of the erstwhile Brown Boveri and the Swiss parent which saw the former enjoying greater autonomy compared to its less autonomous position now—post-merger. This, they opine that ABB's matrix structure might represent only an intermediate step within a rising tendency leading to centralized and global corporate governance, that limits the local autonomy not through a classical authoritarian organizational structure, but through the rational, technocratic devices of coercive comparison. This view is supported by the ongoing restructuring of ABB. As Barnevik's successors Göran Lindahl and Jörgen Centerman realized that the matrix structure caused overlapping jurisdictions between global business sectors and the country network, they went on to increase power at the global management level. The autonomy of local management has been further diminished by a new sectoral (1998) and, then, a new functional customer-centric structure (2001) embraced by the company. All this suggest that the engineering giant virtually ceases to comply with its managerial philosophy of 'Being local worldwide'.

Experts also blame some of Barnevik's risky big bets in power generation and railway transportation for the poor performance of the company in the late 1990s. Many of the company's investments turned sour, notably in

ABB's Matrix: Losing Stitches?



Source: University of Southern Denmark, Oden, Denmark.

ABB emerged as a truly global company with operations in over 100 countries and with 1000 separate units

Responsibilities in the Matrix

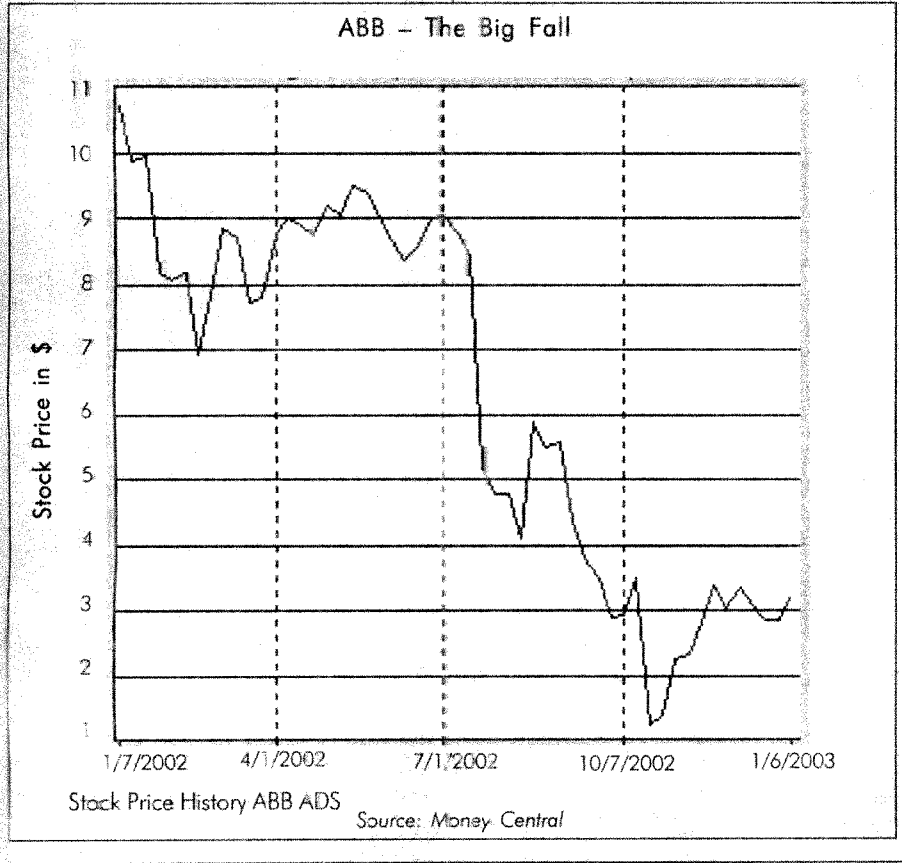
Business Area Manager	Local Manager
• Global Strategy	• Regional Strategy
• Worldwide Results	• Regional Results
• Research and Development	• Management of the Local Business
• Product and Production Coordination	• Customer Relations
• Supply Management	• Human Resources Development
• Know-how Transfer	

Source: University of Southern Denmark, Oden, Denmark.

Latin America and Asia. Though by that time Barnevik had passed on the CEO's baton to his confidante Göeran Lindahl, critics opine that the outcomes were purely related to his earlier decisions. In hindsight, this also raises the issue of whether his global conglomerate with strong local identity was conducive enough to adapt to the changes taking place in its core business areas. Barnevik's decisions to put major investments in power and railway transportation, by the late 1990s proved to be bad. Low margins and high capital expenditures were taking a toll on the company's financials.

Lindahl acted to rectify mistakes of some of the ill-fated decisions of his mentor. It was to his credit that he pulled out of the rail joint venture with DaimlerChrysler in 1999, recouping $472 mn worth of investments. He also ended the company's joint venture with French Alstom regarding power generation in 2000. However, the growing feud at the top ensured that Lindahl too had to quit. ABB was hit badly in 1997 during the economic meltdown in Asia, although the region accounted for only about 12% of its revenues and Barnevik was no longer the CEO, he could not escape the blame of choosing the wrong horse (his successor) for the course, or maybe he did not ride it too well.

A month later though Barnevik, insisted that his salary and pension during his 17 years as CEO were based on agreements with the company and its results, agreed to handover 60% of the pension money. The company is now pushing his handpicked successor Göeran Lindahl, who was forced out as CEO at the end of 2000, to return more than half of his $51 mn pension and severance package. Though feuds at top management is not uncommon in the country (remember UBS, CSFB, Swiss Air and Swiss Life?), the unceremonious exit of a company's founder and a former CEO in this manner is certainly a rarity. Although there are no allegations of financial maneuverings (except at UK subsidiary) or dubious deals done on part of the company till now, the probability of some wrongdoings by former top executives cannot be ruled out completely. In fact, a section of the market participants have expressed concerns that the happenings at the company suggest that some other problems might be lurking in its backyard.



> **ABB had diversified into too many different businesses many of them non-core sectors on which it could not have adequate control and accountability as per the matrix system.**
>
> **Ashok Kumar**
> *CEO, Lotus Strategic Consultants*
> *Mumbai*

Nonetheless, the recent revelations were a serious blow to the reputation of a company that was always proud of its American-style multinational culture. Certainly, the manner in which the top executives of the company acted and the leniency of its board to deter such malfeasance raise serious concerns about the issue of corporate governance at the company. In fact in recent times, with due courtesy to Enron, increased shareholder activism, spearheaded by Ebner & Co. has shaken many corporate boards in Switzerland. This will surely be a good thing for corporate Switzerland.

Is the 'matrix' dead?

During his heydays, Barnevik embarked on sewing a number of fast-paced merger deals. In one of

his interviews in 1987, a year before ABB came into existence, he remarked that he knew he had violated every norm governing the takeovers, but it was more important to be fast than thorough. In his own words, "If you do 50 things, it is enough if 35 go in the right direction." He boasted that a basic rule is to take the initiative and do the right thing. The next message is "take the initiative even if it subsequently leads to wrong things," he quipped; adding, "the only thing we cannot accept is people who do nothing."

Experts opine that at first Barnevik's full-speed-ahead approach proved to be a success. However, today they blame the very breakneck 'speed', for the rising cloud of asbestos-litigation dust hanging over the company at the moment. When ABB announced the $1.6 bn purchase of US power generation firm Combustion Engineering, in November 1989, experts said that Barnevik failed to recognize the problem that the asbestos business had been facing until the early 1970s. Now the company has been paying dearly for that poor-sighted decision; the company recently announced that asbestos-related liabilities of its US subsidiary might now exceed the value of CE's assets, if CE's historical settlement policies are continued into the future.

Experts say that Barnevik literally destroyed those two companies (Asea and Brown Boveri) together. People wondered at Barnevik's breakneck assembly of a diffuse worldwide group, with operations spread across 100 countries, split into some 5000 local profit centers, with a 'matrix' of parallel, local and global command chains. The embattled ABB and its top executives are realizing the fallacies of the matrix structure. There is a vast duplication of effort at the company, right from the R&D activities to IT: The company had 576 enterprise resource planning software systems. In another example, in one of the company's global subsidiaries there were 60 different payroll systems, whereas, in another of its subsidiaries it had 38 agencies where it might have needed just a couple or a few.

Today, the so-called matrix is undergoing a transformation phase. Over the last year, frequent reshufflings at the top have seen the matrix incomplete and being replaced by a far more centralized model. In the new scheme of things, the country managers have been stripped off most of their power and those powers have been transferred back to the company's headquarters (read top management). By 2001-end, post-Barnevik time, the number of profit centers in the group had shrunk to 400, with 7,000 jobs being lost in the clean up.

Yet the problems on financial front have persisted with margins coming under pressure and with the company failing to meet revenues and profitability targets consistently. In fact, this was reflected, when Dormann, the new Chairman of the company, admitted recently that he wanted to change the culture of over promising and not delivering it.

In a significant development, the company recently overhauled its organizational structure. It is realigning its structures from five to three divisions, to further sharpen its focus on power and automation technologies for utility and industry customers, simplify the organization, improve efficiency and cut costs. The two new core divisions are Power Technologies,

ABB's Financials – The Mounting Woes

All figures in US$ millions (except per share data)	Jan.-Sep 2002	Jan-Sep 2001	Change
Group revenues	16,042	16,363	-2%
Utilities	3,543	3,974	-11%
Industries	3,093	3,632	-15%
Oil, Gas & Petrochemicals	2,887	2,450	18%
Power Technology Products	3,220	2,876	12%
Automation Technology Products	3,672	3,590	2%
Financial Services	1,034	1,251	-17%
Corporate/Other	-1,407	-1,410	
Group EBIT margin	2.5%	4.4%	
Utilities	2.1%	3.1%	
Industries	4.1%	3.6%	
Oil, Gas & Petrochemicals	3.8%	4.9%	
Power Technology Products	7.5%	6.7%	
Automation Technology Products	7.5%	8.8%	
Financial Services	n.a	n.a	
Corporate/Other	n.a	n.a	
Net income	-82	289	
Earnings per share (US$ basic and diluted)			
–Income from continuing operations	0.04	0.30	
–Net income	-0.07	0.25	
Net cash provided by operating activities	-234	187	

Financials for the 9-month period ending September 30, 2002

Source: ABB

which combines the Power Technology Products and Utilities divisions, and Automation Technologies, which combines the Automation Technology Products and Industries divisions. The new Power Technologies division, serving utility customers, will have about 43,000 employees and around US$ 8.5 bn in annual revenues. The Automation Technologies division, focusing on industry customers, has about 63,000 employees and around US$ 9.25 bn in revenues. The Oil, Gas and Petrochemicals division will be maintained as a separate unit. ABB said it would explore opportunities in the current process of consolidation among suppliers to the large oil, gas and petrochemicals companies.

Further as a step to simplify the worldwide organization, the engineering conglomerate is dissolving its Group Processes division, which has led the standardization of processes. The process areas that have not already been embedded in the businesses will be integrated into the divisions. "The new structure will allow us to serve our customers better, enhance the external focus and more closely integrate our senior managers in local markets into our global management teams," Dormann said. "We will push out more responsibility to our business operations so that the front-line managers who run the operations around the world have accountability for cost control, as well as for revenue growth," he added further. The company said that the new organizational structures would be implemented in the fourth quarter. The company will report its financial results according to its present organizational structure in 2002, and according to the new structure from the first quarter of 2003. These measures follow a restructuring program that was announced in July 2001. At the end of September 2002, excluding acquisitions and divestments, a total of about 13,100 jobs had been reduced.

Notably, the new management has made it clear that in future, the group won't make acquisitions by "hanging new businesses onto the end of a curtain rod." Perhaps this was in reference to Barnevik's obsession with information technology during the Internet bubble.

Will the giant recoup?

As the economic slowdown lingers and asbestos-related litigations keep rising, the engineering conglomerate faces challenging days ahead. The new Chief Executive has announced a series of measures to increase operational performance and cash flow besides streamlining the company's divisional structures to boost its leading positions in its core power and automation technologies, secure greater external focus and build a sustainable lower cost base. In addition to the group's ongoing program to lower costs by US$ 500 mn—which will have full effect from mid-year 2003—the Board of Directors decided to initiate measures to further reduce the cost base by around 4% of revenues, or US$ 800 mn over the next 18 months. The management hopes that these measures will allow the group to build on its leadership positions in power and automation technologies, and secure competitive cost and profitability levels even in a weak market. Dormann emphasizes that achieving a significantly lower cost base is the key priority. He asserts that the company's restructuring initiatives are very much on track to reduce its net debt by at least US$ 1.5 bn by year-end 2002 from US$ 4.1 bn at year-end 2001.

With the asbestos monster threatening to cost the company its life, it is considering various options for resolving the asbestos liability

However, the concerns over asbestos-related liabilities still weigh heavily and cast doubt over the company's ability to turn its fortune (it recently admitted that it is likely that the expected asbestos-related costs of its US subsidiary Combustion Engineering, Inc. (CE) now exceed the value of CE's assets, if CE's historical settlement policies continued in the future). CE has so far paid almost US$ 900 mn to settle previous claims; the US subsidiary's book value stood at US$ 812 mn, as on September 30, 2002. During the first nine months of the fiscal 2002, the company settled around 45,400 new claims, compared to 39,700 during the same period last fiscal. Settlement costs prior to insurance reimbursement were US$ 161 mn (US$ 103 mn in the first nine months of 2001). According to the company, new claims (15,900) increased by 5% over the second quarter of 2002, while settled claims (7,600) went up by 9%. At the end of September 2002, 111,000 claims were pending (102,700 end of June 2002).

With the asbestos monster threatening to cost the company its life, it is considering various options for resolving the asbestos liability and this includes the possible reorganization of CE under Chapter 11 of the US Bankruptcy code. No doubt, ABB's ability in dealing with litigations would play a crucial role in its recovery. And, it has to act fast.

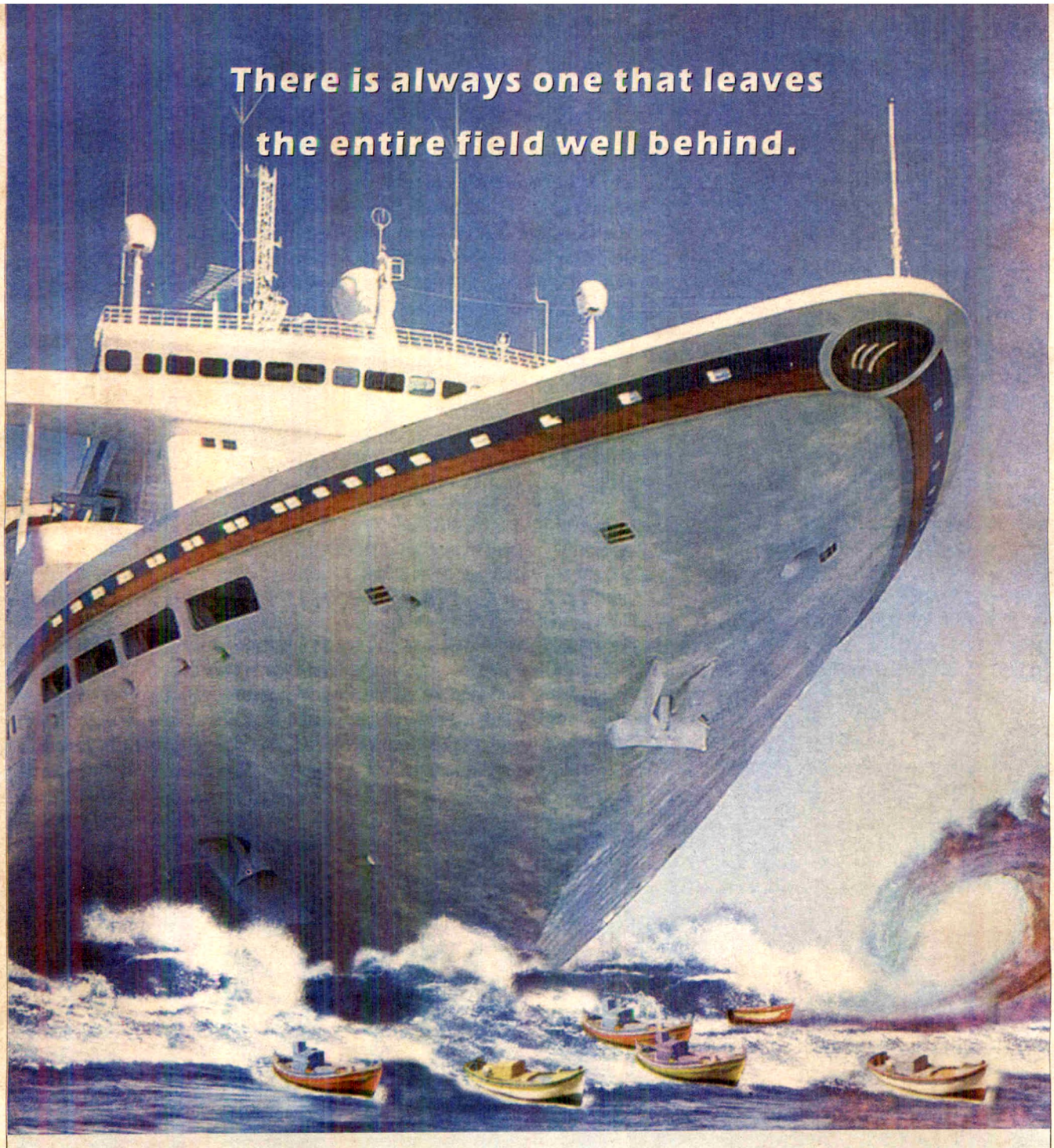
Amit Singh Sisodiya

Reference # 1-2003-02-06

CHARTERED FINANCIAL

ANALYST

Survey of Insurance Sector



We started out 83 years ago with only the trust of our customers. As it grew, so did we. And how! Today, we're the largest general insurance company in Afro-Asia (excluding Japan) and the first Indian company to cross Rs.4000 crore premium income.

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Indian Insurance: Evolving with Time

Over a period of two centuries, the Indian insurance industry has gone through the full circle. From being an open competitive market, it went through nationalization and has been subsequently liberalized again. Keeping in mind the national economic and commercial objectives of India, the government has set up IRDA through which the reforms process of the industry got underway.

The rationale behind the opening up of the sector was to give individual and corporate insurance consumers a competitive environment that can deliver products and services in tune to their requirements. At the same time, an open insurance market will enable capital formation, reducing the need for India to seek external capital to support its infrastructure development program. The industry is believed to benefit from the increased private participation especially in terms of technology transfer from other global players as these players enter into joint ventures with Indian counterparts. The partnership between Indian and foreign firms will also enable the market to grow beyond the current rates and will offer wider choice for the consumers through the introduction of new products, service and price options.

From the time when Life Insurance Corporation and General Insurance Companies dominated the market, the market has undergone a change with the entry of new players both in the life segment and general insurance segment. New players are aggressive in their marketing campaigns and are challenging the LIC, virtually in all aspects. The market is poised for a high growth since the extent of market that was being tapped by LIC so far is very less compared to the global standards. The share of Indian insurance in the total global market stood around 0.41% in 2000. When calculated as the premiums in percent of GDP, the figure stands around 2.32, whereas countries like United States and Japan have 8.76 and 10.92 respectively. These figures indicate the extent of untapped potential of the Indian insurance market.

The availability of multiple distribution channels like agents, bancassurance etc., is enabling the players to expand their reach. Also, the entry has brought in a customer-centric culture and this is radically transforming the insurance business. Traditionally, a claim settlement used to take at least five to seven weeks. Today, the duration has come down to 1-3 weeks. New rules and norms have brought in better governance practices. The changes witnessed by the Indian insurance industry are only an indication of its future. This will go a long way in making the industry effective and efficient.

Y Chandra Sekhar
Survey Editor

CHARTERED FINANCIAL
ANALYST

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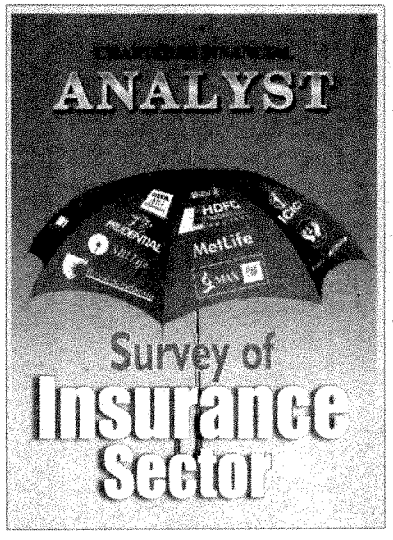

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(Editorial Team: Y Chandra Sekhar, Atul Swan, B S H Shibili)

The views expressed herein are those of the authors and do not necessarily reflect the viewpoint of the organizations with which they are associated.

A High Growth Market

By
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Royal Sundaram Alliance Insurance Company Limited
Chennai

The two dominant factors guiding the penetration of insurance in India are affordability and a clear understanding of the risks. With FICCI describing the Indian insurance market as being one of the least insured markets in the world, there is an immense need for insurance and the understanding of insurance in India.

The Indian insurance industry can look at adopting certain innovative trends in practice in the developed markets. The most prominent being distributing insurance as a commodity through new channels like supermarkets, shops and the Internet.

The Indian insurance sector is a growing industry. With private players in the sector, the Indian customer today is being treated to efficient service, unheard of add-ons, tech-savvy agents and speedy claim settlements. Today's customers demand innovative insurance solutions to their problems and superior quality service. They are now equipped with information, and are more educated, less loyal, and highly independent. Their evolving needs are driving companies to respond more efficiently.

Thus, insurance companies are looking at a marketing strategy that will reposition different products by changing customer attitudes. This can only be achieved through differentiated products and need-based selling communication and service. Therefore, competition, which had eluded the market for long, would unfold innovative products to suit unique customer requirements besides new marketing techniques to reach them effectively to the large untapped Indian market.

Royal Sundaram offers the Indian customer a range of innovative general insurance products. Customized products are provided to customers of banks, based on their requirements. Generating awareness and developing need-based products, Royal Sundaram stands committed to serve Indian consumers with a portfolio of insurance products best suited to their interests with assured levels of service. The Company is constantly on a development and upgradation mode, as it realizes that insurance is a high involvement product and companies will need to customize services for enhancement and retention of customers.

The Company's suite of products include:

- Health Shield, which enables the policyholders to access their network of over 135 hospitals across 25 cities in India. A notable feature of Health Shield is the provision of a Cashless Facility. Other key benefits include a 24-hour helpline and online access to medical and claims information, ambulance referral facility for all our health products and direct settlement of bills with the hospital.
- Royal Sundaram also provides Fiat customers insurance protection through its quality motor insurance product Fiatshield. In addition to providing a comprehensive insurance package for motorists, Royal Sundaram offers its customers a Cashless facility for claims across the country at authorized dealers and workshops.
- Royal Sundaram's Travel Shield is a comprehensive travel insurance, which covers all eventualities that can occur during overseas

travel, under one policy enabling the insured to travel with the most valuable asset 'Peace of Mind'.

The Company's commercial products provide a wide range of specialized and tailored covers to large and medium corporates and include fire, marine, engineering, public liability and product liability covers.

The Company recognizes its responsibility towards the vast rural sector. It currently provides Livestock Insurance and will look to introduce a range of products, including:

- Rural Personal Accident Cover.
- Farmers' Package Shield—that covers assets, including livestock and machinery of farmers.
- Kissan Pump Shield.
- Rural Microenterprises Package Policy.

Royal Sundaram offers a suite of products—covering offices, shops, dealers/distributors and retailers, hotels, manufacturing industry, motor dealers and property owners—specifically designed to meet the requirements of every entrepreneur. They include:

- Business Insurance
- 360° Policy
- Office Shield
- Property Owners Package
- Traders Shield
- Hotel Shield
- Excelerator

All these products are available through Royal Sundaram's vast network of agents across India.

Royal Sundaram recognizes its responsibility towards the vast rural sector. The Company has to its credit a path breaking initiative of insuring members of the Working Women's Forum under a health cover.

Through its partners, agents and in due course, brokers, Royal Sundaram provides a full range of general insurance products including motor, health, accident, travel, home, commercial and SME insurance. We are also looking forward to introduce some new insurance products with our partners in the near future.

What are the various strategies that are being implemented and that can be implemented to increase the penetration of the insurance market in the country?

The two dominant factors guiding the penetration of insurance in India are affordability and a clear understanding of the risks. With FICCI describing the Indian insurance market as being one of the least insured markets in the world, we would like to agree that there is an immense need for insurance and the understanding of it in India. In this context, Royal Sundaram, through its insurance education and awareness initiatives aims at fulfilling the gap in information and also understanding unique requirements of customers.

Bancassurance model of marketing and distribution, through partnerships with various banks, is an effective marketing tool in India

Royal Sundaram distributes insurance not only through its partner Sundaram Finance's distribution network of 110 branches in India, but also uses the support of other banking and finance distribution networks. The Company's Bancassurance model of marketing and distribution, through partnerships with various banks, is an effective marketing tool in India where local and multinational banks have very strong brands and even greater customer loyalty.

Also, as the Company's potential customers are large and medium corporations, select small-medium enterprises, the rural segment and personal line consumers, strategic alliances with multinational banks such as Citibank, Standard Chartered Grindlays Bank, ABN-Amro Bank and American Express Bank provide excellent channels to market general insurance products.

Besides the above, following the liberalization of the insurance sector in India, the Indian insurance market is regulated by the IRDA. One of the important objectives of the IRDA is to protect the interests of policyholders so as to increase public confidence in insurance products. In order to achieve the said objective, the IRDA issues various notifications and regulations from time to time.

The IRDA (Protection of Policyholders' Interest) Regulations, 2001 lays down certain directives with respect to claim settlement. The aforementioned regulations apply to general and life insurance policies and aim to specify minimum standards from the point of sale of the policy to settlement of the claim. The main features, as far as claims relating to general insurance policies are concerned, are as follows:

- The insurance company must offer a fair settlement of the claim rather than "try to improperly beat down the claim taking advantage of the policyholder's need for an early settlement."
- The insurance company must make its offer of settlement within 45 days of the receipt of all documents and information asked for, and make payment within seven days of the policyholder's acceptance.
- The Board of Directors of an insurance company must, at least once a quarter, review the number of claims notified in the preceding quarter; the number of claims settled and outstanding during that quarter; and an analysis of how long it has taken to settle claims.

Obligations are also placed on policyholders, who must state correctly all relevant facts for the grant of a cover and in settlement of claim arising thereunder, and provide all information sought from them by the insurance company to enable the risk to be assessed.

The IRDA has also issued other regulations that have been issued to enhance policyholder protection viz., the IRDA (Insurance Brokers and Insurance Consultants) Regulations, 2002, which have been framed to govern the conduct of brokers as and when they are permitted to operate in the Indian market. Under these regulations the brokers are allowed to maintain proper records of claims and assist in the negotiation of claims.

Besides the above, the RBI has also issued regulations governing the settlement of claims in foreign currency. As per Circular A.P. (DIR Series) Circular No. 8, the settlement of claims in foreign currency with respect to such policies is permitted by insurance companies subject to the following conditions.

- The policy has been issued in foreign currency with specific approval.
- The claim has been made for the loss occurred during the policy *per se*.
- The claim has been admitted by the competent authority of the insurance company.
- The claim has been settled as per the surveyors' report and other substantiating documents.
- Claims on account of reinsurance are lodged and settled as per the reinsurance agreement.
- The remittances being made to the non-resident beneficiary under the policy. For resident beneficiaries the claim may be settled in rupee of foreign currency due. Under no circumstances payment in foreign currency will be made to a resident beneficiary.
- While settling such claim RBI approval for issue must be obtained and quoted .

Conclusion

In spite of the aforesaid regulations, a major challenge that remains to be addressed is to ensure that the new insurance regulatory regime works towards eliminating corruption and ensuring that claims are processed efficiently and quickly. Efficiency in handling and settling of claims will go to show that privatization of the insurance sector has been a boon for the claimants and the country. ◘

Risk Management

By
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Member – IRDA Advisory Committee

Risk management signifies a different type of approach to the handling of risks, involving a systematic study of problems within the context of the whole organization and developing a comprehensive strategy based on information and devices available to the firm.

"Risk Management is a new name for an old idea", is what JA Dixon, former Head of Insurance of Unilever, said about the concept. He adds further, "As often happens, a change of name or the giving of a name to a previously anonymous function, generates greater interest of acceptability or even enhances status—an Office Manager is obviously of higher standing than a Chief Clerk, and a Waste Disposal Operative is far more a force to be reckoned with than the man who empties the dustbins. In economic terms, it counts more to talk of the Law of Diminishing Returns than to say that if you flood the market or force up prices, sales will ultimately falloff!"

What then is 'risk management'? Is it the same as 'insurance management'?

Risk has been defined in the Concise Oxford as "hazard, chance of bad consequences, loss, etc., exposure to mischance".

Risks are present "around every corner and under every stone".

In the ancient Indian scriptures, it was said that man, being the ultimate maker of his destiny was supposed to conquer *Vidhi* or fate or chance by *Mati* or intellect.

We also come across a pithy saying (Deuteronomy 22: 8 Holy Bible) as follows: "When you build a new house, you shall make a parapet for your roof so that you may not bring the guilt of blood upon your house, if anyone falls from it".

Thus, from the distant past, mankind has recognized the need for safe-guarding against the bad consequences of risks and chances which are inevitable in the environment.

In fact, risks are inherent in every walk of life. The "complete elimination of risk could, of course, pose us a severe philosophical and practical problem in the elimination of uncertainty" (JE Bannister).

Peter Drucker, a reputed Management Expert, is of the opinion that "to try to eliminate risk in business enterprise is futile. Risk is inherent in the commitment of present resources to future expectations. Indeed, economic progress can be defined as the ability to take greater risks. The attempt to eliminate risks, even the attempt to minimize them, can only make them irrational and unbearable. It can only result in that greatest risk of all, 'Rigidity'.

But, at the same time, Peter Drucker has cautioned that "the main goal of a management science, must be to enable business to take the right risk. Indeed, it must be to enable business to take greater risks—by providing knowledge and understanding of alternative risks and alternative expectations; by identifying the resources and efforts needed for desired results; by mobilizing energies for contribution and by measuring results against

expectations, thereby providing means for early correction of wrong or inadequate decisions." This takes us back, closer to risk management.

Thus, risk management signifies a different type of approach to the handling of risks, involving a systematic study of problems within the context of the whole organization and developing a comprehensive strategy based on the information and devices available to the firm. It is part of the revolution which has changed management practice in the past 50 years, embracing an ever-growing set of ideas and techniques, often collectively called 'Scientific Management' (*The Handbook of Risk Management*-Kluwer-Harrap Publication).

Is risk management synonymous with insurance management? With traditional insurance management, insurance is effected against those risks which has been the common practice for most commercial companies to insure. A correct evaluation of the risks to which the company is actually exposed, is not carried out and that is why, we come across many instances of companies having insurance policies which they frankly do not need because the risks are too small. More seriously, there are examples of companies which do not have complete protection because some of the risks have not been correctly identified.

Risk Management, thus, is not the death knell of traditional insurance, but, in the words of Mehr and Hedges, in their book *Risk Management in the Business Enterprise*— define it "as a managerial function is something more than corporate insurance management and something less than all management".

Why risk management?

A 'risk', in the corporate terminology, is an unwanted and uncertain event. When a 'risk' operates, it leads to consequences which will affect the profitability of the business. Thus, before the risk operates or strikes the business, it is necessary for the management to know something about the possibility of the event occurring and its cost to the firm if it does occur. This will enable the management to improve the quality of decision-making and the ways and means of handling the risk.

Thus, an ideal risk manager will:

- Consider the impact of risks on the performance of the firm;
- Consider ways and means of preventing, reducing or minimizing the losses through the identified risks;
- Consider the best way of transfer of risks (insure).

Nature of risks: Static and dynamic

To understand the concept of risk management, it is necessary to consider the nature of risks themselves and risks could be grouped as:

- Pure static or fortuitous risk
- Speculative, dynamic or entrepreneurial risk.

Pure, static or fortuitous risks always result in a loss, e.g. fire, explosion, accident, etc. Insurance is normally arranged against these risks. In other words, these risks can also be termed as the sources causing physical damage to assets, fraud and criminal violence, third-party property damages, death/disability of employees/owners, etc.

Speculative and dynamic risks relate to the consequences of management risks relating to the functions of marketing, finance, production, innovation of the entrepreneur or the management. In other words, these are the fundamental risks against which it is not normally possible to obtain insurance protection.

It has been said that the risk manager should not dabble in dealing with the dynamic risks. While it is conceded that the risk manager is certainly more concerned with the fortuitous risk to which everyone running a business is exposed, risk management techniques can be adopted with advantage to assess the speculative and dynamic risks also.

"The risk manager is, thus, more intimately involved in every aspect of his concern's affairs and is expected to talk or listen to all and sundry with sufficient understanding to appreciate everyone's problems and translate these into legal, financial and physical consequences, and, above all, having appreciated the consequences, suggest ways of prevention or minimization" (JADixon, former Head of Unilever Insurance).

Role of corporate insurance management

Before we examine the risk management process and the role it can play in the corporate sector, we can examine briefly as to the role of the corporate insurance department in the industry.

We come across two different approaches to insurance from the corporate side.

Firstly, it is the 'head in the sand' approach, viz. to view insurance as a cruel financial necessity or a necessary evil. Here, due to ignorance, as Insurance is inadequately arranged for lesser sums or fewer risks, the company is exposed to large losses which it cannot bear.

Secondly, it is the "insurance of everything in sight" idea. In fact, this is a dangerous proposition, insofaras a sense of false security is implanted at all levels of management because of omnibus protection.

Risk management will strike a balance between the two extreme views on insurance, as described above. The risk manager will find out the budgetable and acceptable losses and differentiate it from the unbearable or transferable catastrophic losses. Whereas, the former risks are self-insured, the latter risks are identified, reduced or minimized so that the catastrophic risks are contained in their consequences to safe marginal limits.

Risk management practice

This process consists of the following steps :

- Risk identification
- Risk evaluation
- Risk removal
- Risk reduction
- Risk re-evaluation
- Risk assumption
- Risk transfer

Risk identification

One thing is certain. Risk cannot be identified from behind an office desk. Risks can be identified only through "eyes and ears, a substantial imagination and plenty of shoe leather" (AJ Ingly). The risk manager must first seek to pinpoint the risk sensitive areas and situations with significant loss potential and then go on to identify the perils and hazards associated with it.

Two figures are given below, which would explain the two ways of identifying the risks.

Figure 1*

Cause	Effect
Natural Phenomena	Liability (damages)
Breach of Natural Laws	Property Damages
Man's Activities	Bodily Injury
	Loss of Earnings

Figure 2

Cause		Effect
Natural Phenomena		Liability (damages)
Breach of Natural Laws Man's Activities	Loss Producing Event	Property Damages Bodily Injury
		Loss of Earnings

* *Handbook of Risk Management*

New Distribution Channels

Direct marketing

Direct marketing is one of the most successful channels of distribution in the developed economies. It is a great way to reach a large population. Typically, Direct Mail (DM) or Telemarketing ™ is used. It is important to target the right customer with the right affinity and message. For example, a high-income person may be interested in a whole range of life insurance product while a rural farmer may be interested in protecting the family's assets. The ability to mine data is very important.

Products: Products sold through DM are plain vanilla insurance covers with simple underwriting. Personal accident policies, term policies and other simple products tend to work better than complex participating or unit-linked products.

Our overall approach to product offering is to look at the needs and requirements of the Indian consumers and customize the products to meet the needs of as many segments of the Indian consumer as possible. We are offering four different Endowment Plans, Whole Life Plan, Money Back Plans, seven different term insurance options, a unique term with Refund of Premium Plan with a guaranteed addition and seven different rider options, including two forms of critical illness coverage. Most life insurance plans can be combined with the various riders to provide the customer with a multitude of options.

On the corporate insurance side there are group term life, group accident plans, mortgage plans, credit card term protection plans, personal loan term protection plans, gratuity and superannuation schemes amongst others. Tata AIG is also tapping the captive market in the 2,30,000 employees of various Tata group of companies. With the combination of these distribution channels, Tata AIG is looking at a growth of 100 to 150% in the current year over the previous year.

A critical success factor is an emphasis on exceeding customer expectations with excellent products and service. As has been seen in other financial services, the entry of private players ensures that customer will be the beneficiary in the long run. It will also result in growing the market and extending the reach of insurance across the country.

To be successful, a company must have quality people, innovative management, be able to employ technology effectively besides having the right products and distribution channels

New products and new technology will play a crucial role in reducing the cost and, therefore, make it cost-effective to serve the large population in India. Having the right target market, the right product mix through add-on benefits and riders, effective branding of products and services and differentiation from competitors' offering will be the key challenges faced by insurers.

To be successful, a company must have quality people, innovative management, be able to employ technology effectively besides having the right products and distribution channels. Finally, the partnership that the new entrant has entered with brings with them a source of strength such as providing technology, ready customer base as well as a trusted name. ◘

A Viable Proposition

By
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Across Europe, in countries like Spain and UK, banks started the process of selling life insurance decades ago and customers found the concept appealing for various reasons. Purchasing life insurance from the bank was easier for the customer than approaching an agent.

What is bancassurance?

There are many definitions to bancassurance. However, the one that is most commonly used is:

"manufacturing and distributing cost-effectively banking and insurance products to a common customer base" (Mercantile and General Reinsurance).

Bancassurance, in its fully realized form, is a holistic model using the strengths of both the insurer and the bank. It is not about just selling insurance through the bank as is commonly understood. However, in India the concept of bancassurance is just emerging and is in fact another distribution channel for insurers. Bankers are acting as agents for insurance companies to offer the insurance products to their customers.

Traditionally, insurance has been sold through individual agents. It is often said that life insurance is never bought but always sold, and this requires somebody to sit with the customer face-to-face and sell the concept. World over individual agents played a key role in developing the business. Good agents have played various roles of a life advisor, financial planner and one of becoming an integral part of the client's life. In the US, this gained prominence with some of the richest and most successful men being life insurance agents sharing the platform with real estate agents, stockbrokers and the likes.

Origin of bancassurance

Across Europe, in countries like Spain and the UK, banks started the process of selling life insurance decades ago and customers found the concept appealing for various reasons. The customer found purchasing life insurance from the bank much easier than approaching an agent. There was also a comfort

Bancassurance is just emerging and is in fact another distribution channel for insurers. Bankers are acting as agents for insurance companies to offer the insurance products to their customers

in the fact that one could pay premiums through one's bank account and also approach any bank branch for service rather than depend on the individual agent who may have left the business. In the US, the Glass Stegall Act prevented banks from getting into insurance business till the early 1990s. While the concept of banks selling insurance emerged in Europe, the United States and many other parts of the world continued to associate individual agents with life insurance selling.

Why should bancassurance succeed?

Let us look at some of the reasons for probable success of bancassurance in India:

Large captive customer base

An individual agent has to find prospective customers. Banks have millions of depositors and

account holders who could be potential customers for life insurance selling. One of the primary reasons for the success of bancassurance is the fact that the bank need not look outside their own captive customer base to sell insurance.

Faith and relationship

After all who but the bank represents a symbol of faith and trust wherein the customer puts in his hard earned money. Banks have been around for centuries and customers have come to trust them for generations. Bank managers develop relationships with clients which go beyond just banking transactions and have known to help clients in their dire needs going out of the way. Businesses depend on banks and develop relationships which are mutually beneficial. With this background it would seem logical that the same client would trust the bank or the bank manager for buying life insurance.

Solution and not commission

The bank manager is an employee and not seen as someone trying to sell for commission alone. The bank employee would be trusted to sell the correct solution which the client needs and not the one which necessarily generates the highest commission. Again, the client has trust and is willing to allow the manager to help him buy the right solution.

Geographical spread

The reach of many large banks in India is tremendous next to the ubiquitous Post Offices. Insurance companies see this as an opportunity to reach out to large customer base at a low cost. To set up an agency distribution system for the same would be an expensive and not so productive business.

It would seem almost that banks should succeed in selling life insurance. We shall examine later why this may not be true and what the banks need to do in order to make the potential a reality.

Potential of life insurance in India

Without getting into detailed statistics it is amply evident that the potential for life insurance selling in India is large. After all, we are a population of more than 1000 million! Life Insurance Corporation of India, despite its best efforts, has not penetrated more than 15% of the insurable population, which itself is more than 300 million. Insurance penetration as a measure of percentage of GDP is very low for India and countries like South Korea are much higher than India. With approximately $7 bn of premium collected annually, India is the 23rd largest market in the world with approximately 0.42% of the world's life insurance market. With 7% GDP growth rate, the total market size is expected to be approximately $25 bn by 2010. This, undoubtedly, makes India a hugely lucrative and untapped market.

Potential of bancassurance in India

It is difficult to estimate the percentage share of the total market which would be captured by banks. In countries like Spain, more than 70% of the total insurance is sold through banks while in the US it is less than 10%. In India, many banks and financial institutions have set up joint ventures with foreign insurance companies. Some examples are SBI Life (with Cardiff of France), ING Vysya (ING group and Vysya Bank), MetLife India (MetLife and J&K Bank amongst others), ICICI Prudential (with ICICI), HDFC Standard Life (with HDFC) etc. Companies like Aviva, MetLife, Birla Sun Life, SBI Life etc., see bancassurance as an important channel for distribution.

One of the primary reasons for success of bancassurance is the fact that the bank need not look outside its own captive customer base to sell insurance

Let us examine some of the factors which banks need to consider before venturing into insurance selling.

- **Bank culture:** Most of the traditional banks in India are not used to 'selling' i.e., going out to the customer to sell their products. They are used to

transacting with the customer in their bank branches and have rarely gone out to solicit customers. Given the nature of insurance selling, this would require a shift in mindset and a change in the total culture of the bank. The bank should be prepared to make this change a reality.

- **Products:** Banks need to sell simple, transaction-based products which are easier to explain and can be sold across the counter. In order to utilize the full potential of the distribution reach of the bank, insurance companies will have to design products which have simple underwriting guidelines, and which can be sold by any person with a minimum training. Complex products like Whole Life, Endowment etc., could be sold by trained employees but this may remain restricted. Banks need to invest in product training.
- **Remuneration:** This can be a thorny issue as the bank employee would expect some part of the commission as an incentive for performance. With unions and other issues, this needs to be dealt with caution.
- **Top management involvement:** Banks need to see insurance as a key to their business strategy and thus invest the necessary resources to make it successful. A casual foray into distribution is likely to meet with failure. Successful bancassurance operations worldwide have the top management fully involved right from inception.
- **Integrated approach:** Life insurance should be a part of the total financial solution offered by the bank. Successful bancassurance models look at offering a range of financial services under one roof.

Regulations to support banks entering into insurance selling are being made and shall go a long way in making this low cost, customer-friendly channel a success

Conclusion

A beginning has been made and we would see various success stories emerge in the coming years. Regulations to support banks entering into insurance selling are being made and shall go a long way in making this low cost, customer-friendly channel a success. ◘

Insurance Landmarks

Some of the important milestones in the general insurance business in India are:

1907: The Indian Mercantile Insurance Ltd. set up the first company to transact all classes of general insurance business.

1957: General Insurance Council, a wing of the Insurance Association of India, frames a code of conduct for ensuring fair conduct and sound business practices.

1968: The Insurance Act amended to regulate investments and set minimum solvency margins and the Tariff Advisory Committee set up.

1972: The General Insurance Business (Nationalization) Act, 1972 nationalized the general insurance business in India with effect from January 1, 1973. 107 insurers amalgamated and grouped into four companies viz., the National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd., and the United India Insurance Company Ltd. GIC was incorporated as a company.

Source: Confederation of Indian Industry, www.ciionline.org

Health Insurance

By
Parakshit Mahajan
COO
East West Assist Pvt. Ltd.
New Delhi

The Indian market is extremely lucrative for health insurance. Figures can be quoted to repudiate this but they could be deceiving. Twenty lakhs of people are covered by any one form of health insurance. So only 0.2% of the population is covered by health insurance, and the rest of 99.8% is still unexplored.

The players in health insurance include the insured and the insurance company. On the clients' perspective we have the Call centers which are run by the TPAs. All the customers call here to know the claims provided by the insurance companies. TPAs play an important role especially in health because the role of brokers is limited to selling only. We are still unaware of the regulations and norms or rules that have been issued. All we know is they are going to underwrite the risk and TPA will be paying for it. If we notice the GIC sector, it is heavily overstaffed. They are definitely not going to make the TPAs successful. That is why the percentage of premium is around 5.5% of net. The reason behind them not allowing us to be successful is 20 of our people could take up the work of atleast 500 of them. This is because, the business strategies we talk of now are exactly related to technology solutions. We have customized change management softwares and we have one man handling 100 claims. If we enter GIC office, you will know how much will happen there and that is why their claim ratio is 197%. Ideally this should be around 40-50%. Worldwide the standard is around 35-40%.

As of now the TPAs cannot sell insurance as per the IRDA regulations and norms. At a later stage, after being allowed to sell insurance as the market opens up, TPAs shall become part of the whole process chain where at present brokers and other intermediaries are present.

Role of brokers

Brokers function as a kind of outsourced office of insurance companies. A very large volumes even for very low margins should end up giving them a lot of business. At the same time they would end up undertaking the risk for the insurance company. It is selling on a mass scale. It could be something like a BPO of the insurance company.

Potential for health insurance in India

The Indian market is extremely lucrative. Figures can be quoted to repudiate this but they could be deceiving. First, to understand how well it is: 20 lakhs is the number of people covered by any form of health insurance excluding those employees who are insured under State or Central Government's health insurance schemes. They are just looking at mediclaims. So only 0.2% of the population (i.e., 20 lakhs) is covered by health insurance. The rest 99.8% is totally unexplored. Out of which 48% cannot afford an insurance as they do not have any savings. But from a perspective of just two million people covered now we would expect the numbers to go up by at least 10 times in future. Out of that 99.8% would be of the GIC sector. Hardly any private health insurance has taken off as on date. Whatever is being done is done through mediclaims. But if the market is very big a lot of companies come in. For example, Nike had a definite business plan. There are some billion feet in India and this would have been a huge

opportunity in India for manufacturing. But it failed to make use of the opportunity and achieve its target. The reason is affordability. On similar lines, health insurance should also become affordable. But on the other side, in the GIC sector United India, Oriental and National have their products priced very low. It is so low that they cannot cover their cost. So they are trying to squeeze the TPAs at 5% and nothing is expected to come out. They need to revamp their pricing in general and the pricing they had given to the intermediaries. Initially, a TPA does a lot of groundwork. It gives a call center, pay for the claims, a card, giving a lot of back office. Finally, it only benefits from 5% of the net premium until and unless a huge volume is achieved.

The state owned insurance companies have to be open to the idea of having a TPA. The licensing has been done by the IRDA; people have invested money, a lot of money and lot of money is required to set up a TPA. Then the regulators do the ground testing. The Government run insurance companies are scared of losing their jobs.

Competition

The competition is increasing between the GIC's and TPA's and the GICs have been left with no choice but to outsource. For example, life insurance sector has a service called Life Assist. A card is given to each insured person and for pre-insurance tests. Each life insurer has to outsource. There is no other option. They cannot sit around to check each person and verify his/her medical tests. The only health insurance providers in India are the four Government Insurance Company's subsidiaries. Since that is the only health insurance and TPAs are also into it they have to outsource it. The TPA sector will die out otherwise and the licensing will be all gone. That is why CII is trying to bring a consensus on this issue so as to leverage the sector. So, the GICs have to get out of their mindset of losing the jobs.

Future of TPAs

We cater to the organized health care market. For example, there are 30 TPAs in the market now. The health care insurance market is around Rs. 500 cr. If this is divided by 30 and multiplied by 5.5%, a figure of 10 crore is the TPA yielding rate. This is because everybody has not got the business. We expect for a leap in the next five years from the existing 500 crore to about 4500 crore in the health insurance markets. The minute the health insurance market opens, we are going to get a good share of the market.

Both brokers and TPAs fall under the category of intermediaries. In India, the insurance market is huge with a handful of people to manage it right from claim verification to estimates and the like. At the end of the day, we see a common platform in the form of a Web-based solution where people could log on, to see the claims status. This would apply to all the intermediaries like the brokers, TPAs and all. Let's say, a broker has issued a Health Insurance policy, the claim for which the TPA will service. Instead of the broker running back and forth with the insurance company it is more convenient when TPA handles. On the whole, the insurance company should come up with a site wherein all the intermediaries can interact.

Improved scenario for TPAs

There was a rumor that TPAs could sell insurance. Then a TPA will also go for a brokering license so as to gain from the chunk of the 20-25% of the brokerage charges. Till date it is not clear about the brokerage charges in the health insurance segment. In the non-life insurance it is quite high. So, the TPA gets only 5% in comparison to brokers. When this goes on high volumes it becomes like a large bank. I feel the relaxations should go hand in hand for TPAs too, so that we could also open brokerage firms along with the existing call centers. ■

Customer Focus

By
Sam Ghosh
CEO
Bajaj Allianz General Insurance Co. Ltd.
Pune

In its first year of privatization, the insurance sector witnessed a number of private sector players queuing up to tap the potential of this lucrative market. The entry of the private players not only increased competition in this sector but also made innovative products available to the customers.

With privatization of the insurance sector the customers' bargaining power has increased. It is a buyers market, with new insurance companies looking forward to gain the market share. Although the growth rate of the economy has been quite impressive in the last decade, the insurance market is likely to witness a sea change in the marketing mix, that is product, price, place (distribution channel) and promotion. The customer-driven market will result in more flexibility and innovations in products' pricing, distribution channels and communication mechanisms. The IRDA, with its developmental and regulatory guidelines, is likely to promote competition, fairness, and reliability, and at the same time, protect insurance against excessive, inadequate or unfair discriminatory rates. The companies want to offer value-added service to the customers and competitive pricing for the products.

In its first year of privatization, the insurance sector witnessed a number of private sector players queuing up to tap the potential of this lucrative market.

Customers focused initiatives

Bajaj Allianz has taken a number of customer focused initiatives like—

- On the spot policy issuance at motor dealers and travel agents which makes it convenient for the customer to get a policy
- Cashless settlement of claims for motor and health guard, which makes the claims settlement hassle-free
- Introduction of innovative products like Hospital Cash and Critical Illness
- Using innovative channels to reach the masses like: i) Tie-up with motor manufacturers; ii) Tie- up with pharmaceutical companies to offer insurance cover through their product; iii) Tie-up with banks, NBFCs and various other institutions.

The majority of insurance companies today are under tariff, that means insurance companies cannot price the product to suit the customer or customer group. The way to service customers is to segment the market and offer the correct product at the correct price to that market segment. This can only take place in a tariff-less market.

There is a huge untapped potential in India, which needs to be targeted. The distribution channel is a medium to reach the masses in urban, semi-urban and rural areas. With a wide range of products being available for different segments in the market, it becomes important to promote them thorough the right channel. Insurance companies can target the existing as well as new customers to offer them different products. Multiple distribution channels also offer cross-selling opportunities.

Further, for new insurance companies, distribution channels like Banks, NBFC's etc., are readymade options as opposed to creating an agency network, which takes time. ■

Technology – A Helping Hand

By
M C Raisinghani
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Birla Sun Life Insurance Co. Ltd.
Mumbai

When competition is intense, technology can play a vital role in differentiating the product and the service to meet the demanding needs of discerning customers.

Though technically, insurance does not come under the purview of technology, insurance companies can benefit immensely by adopting technology. It is not only useful for them in providing better customer service but also in marketing their products and services.

Like any other sector, Insurance industry is also dependant on technology. Two aspects of life insurance business make it very technology dependent. One it is retail oriented, the need to service hundreds of thousands of policyholders in a cost effective manner underscores the need for cutting edge technology. The other, it's a very long-term business where the records need to be maintained, updated and accessed as may be required over the lifetime of the policy contract. This points out for the need for very robust systems platform, which is capable of getting itself, adjusted to the rapid pace of change that the technological world is witnessing today. Added to these two dimensions of business, in the Indian context, Life insurance has suddenly become an extremely competitive business. When competition is intense, technology can play a vital role in differentiating the product and the service to meet the demanding needs of discerning customers.

Technology initiatives

The first and foremost initiative is to set up our systems on a web based unit linked platform. This gave us a tremendous edge in the market in offering a very advanced state of the art product across multiple delivery channels that at one point of time would include the Internet and the Call centers. We have made our policy administration system host integrated with our Internet site and Call center which means, customers can either browse or call up a given number and access the relevant data of their policy records. Not only data access, they can write back for a variety of functions for which they otherwise depend on their agents. We are shortly exploring opportunities to offer select insurance products through online channels.

In the insurance business cost control and ability to service large number of customers are crucial issues. Both cannot be handled without the help of modern technology

Another major initiative is to integrate our web and call center strategies into a single network accessible across cities through a dedicated private network. The Call center is a web based call center which means a person visiting our site can also simultaneously call up our Call center while he is in the same browsing session to check for any additional details with the Call center agent. Some of these features represent next generation technology even by

Technology – A Helping Hand

US standards. However, we are still a few months away in activating these functionalities.

Technology impact

There is a notion prevailing in the Indian market about the impact of technology on marketing and promotion of insurance products. Some argue "Lessons from the developed market suggest that technological edge had little impact in the marketing and promotion function of insurance sector." I totally disagree with this notion. There are strong legacy issues which prevented the insurance industry in the developed world to adopt the best of the breed technology available in the market. India is not fettered anyway in this manner. We indeed have a unique opportunity to showcase to the rest of the world what technology can do in life insurance business and that's exactly what we at Birla Sun Life are doing.

In the insurance business cost control and ability to service large number of customers are crucial issues. Both cannot be handled without the help of modern technology. Any tech savvy company would see this clearly and take leadership in a market which has not been used to cutting edge technology being employed for best of the breed service.

Internet influence

Presently Internet has only a marginal effect in meeting customer's needs in Insurance. But I guess this is going to change rapidly in the years to come, there will be a great influence as a result of Internet on the Insurance industry.

However, security of the information, need based selling, empowering the customer, channel conflict are some of the issues the insurance companies need to grapple with when they deal with technology in its true manifestation. ◘

Total Premiums by Country in the year 2000

Country	Premiums (US$ mn)	Share of world market (in %)	Premiums in % of GDP	Premiums per capita (in US$)
United States	865327	35.41	8.76	3152.1
Japan#	504005	20.62	10.92	3973.3
United Kingdom	236960	9.70	15.78	3759.2
Germany+	123722	5.06	6.54	1491.4
France+	121910	4.99	9.40	2051.1
Italy	63062	2.58	5.80	1084.3
South Korea#	58348	2.39	13.05	1234.1
Canada**	46587	1.91	6.56	1516.8
Spain	37617	1.54	6.73	954.2
Netherlands	36450	1.49	9.87	2290.2
India#*	9933	0.41	2.32	9.9

*Estimated; **Life business: Net premiums; #Financial year 01.4.2000-31.3.2001; +Provisional

Source: www.bimaonline.com

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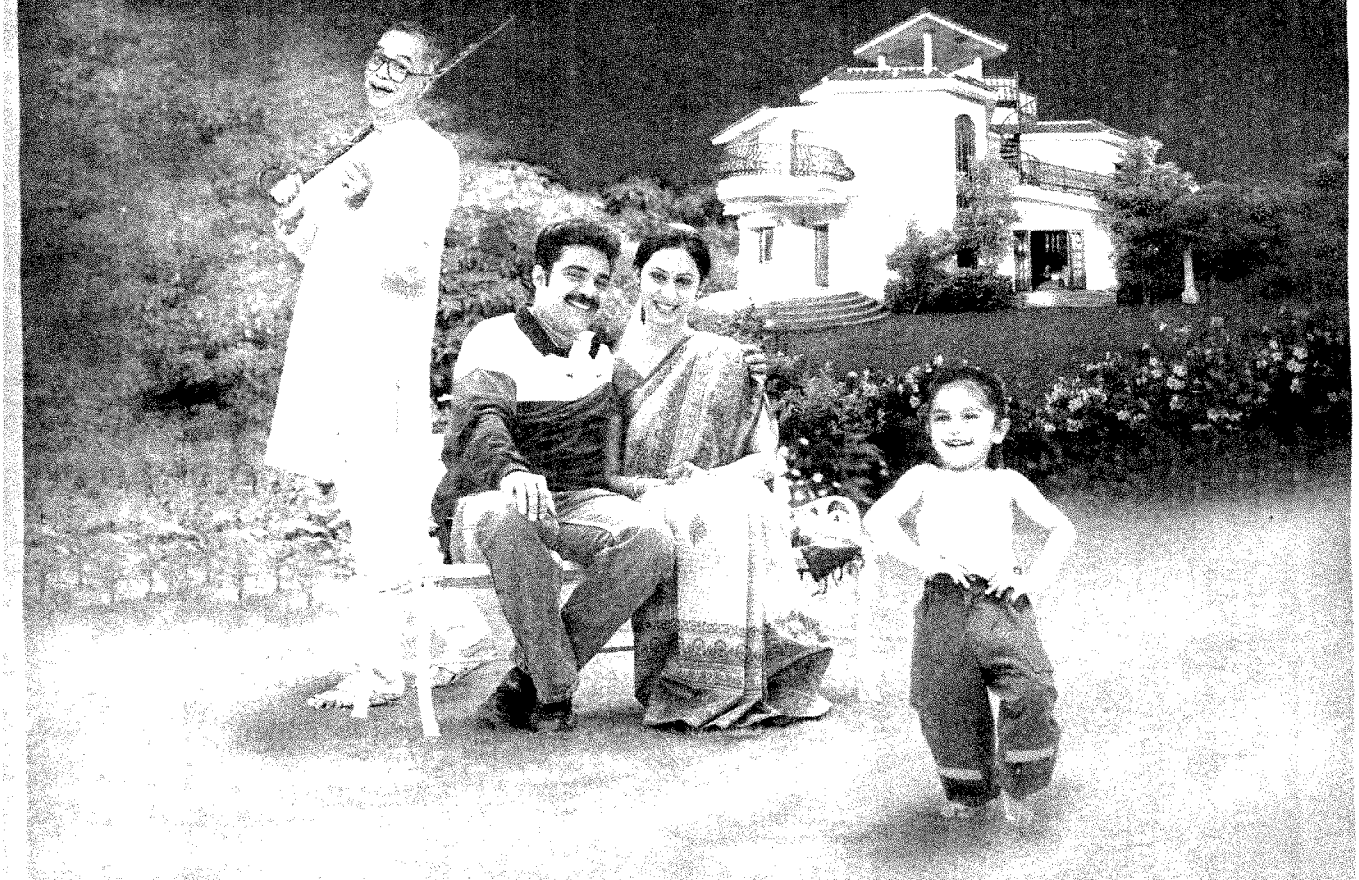

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G.Krishna Murthy
Chairman

Preparing for a Claim

By
Abhijit Ghosal
Technologist (Industrial Insurance Consultancy, Risk Inspection and Management, Survey and Loss Assessment)
Ex-Regional Manager—New India Assurance Co., Kanpur

Insurance policy forms the basis of the written contract entered into between the insurer and the insured. The insurer usually drafts the policy wordings. Hence in case of any ambiguity in the meanings of the wordings in the policy, the court would interpret the policy in such a way so as to benefit (be to the advantage of) the insured.

Insurance is a financial service. It falls under the purview of Consumers Protection Act. The Consumer Forum accepts complaints from the aggrieved insureds and decides such cases.

Insurance claims

The origin of insurance has been from cooperation among risk-takers so as to spread (share) the heavy losses incurred by some amongst the larger number. This harbingers the concept of utmost good faith. If some members of the association, thus formed to ameliorate the misfortunes of the few unfortunate members, change their minds and refuse to indemnify the losses suffered on the occurrence of the contingency, the purpose of the association would be defeated. This would call for advance payment of premium, which is held as a trust.

The definitions of fire, marine and life insurance business contain the essential features of these classes of insurance contracts.

A contract of insurance is not a wagering contract, but is subject to existence of an insurable interest. It is easier to define insurable interest where the principle of indemnity is involved. The principle of indemnity is involved in a contract by which one party promises to save the other from a loss. Except in the cases of life insurance and personal accident insurance, the principle of indemnity is the controlling principle and the policy secures payment of the loss to the insured, subject to the limit of the sum insured.

In fire and life insurance, insurable interest must exist at the time policy is made, while in marine insurance the policyholder must have acquired the insurable interest at the time of loss.

The duty of utmost good faith applies to the insurers who cannot issue a policy when they are aware that the insured has no insurable interest in the property covered or that the property is already destroyed, the insured being unaware of the position.

The principle of indemnity is involved in a contract by which one party promises to save the other from a loss

Both the insurer and insured have to observe good faith when there is a loss. The law expects the insured to act as if he is uninsured. In the event of a loss or damage, the insured has the duty to minimize the loss, to summon the fire brigade at the earliest, prevent aggravation of the loss by removing movable property to a place of safety, and cooperate with the fire brigade or salvage corps in fire extinguishments or reduction of loss.

Usually the subject matter of insurance is an item either owned by the insured or is kept with the

insured. As the insured has been using it for his benefit, he alone is well conversant with all the features of it. The insurer is not having much knowledge about the item to be insured and hence has to rely on the disclosures made by the insured about the hazards/adverse features of the risk (i.e., subject matter of the insurance). This is all the more pertinent in case of insurance of human lives. The life assured knows best about his past medical history and in case he wishes to conceal an impairment, it could be difficult for the insurer to discover the same through routine investigations. Hence, the duty of the insured to correctly answer to all the points on the questionnaire cum proposal form becomes of paramount importance. Usually some insurers convert the representations thus made by the proposer into warranties which later form part of the insurance contract. Breach of such warranties makes the insurance contract voidable at the choice of the insurer.

The insurers too are bound by good faith. They are bound to place a proper interpretation on the terms and conditions of the contract and settle the claim with fairness and equity.

When the loss takes place, the insured has to prove that the loss he has suffered is the result of the occurrence of the peril insured against. At times there are complicated situations in which the insured peril is only one of the several events all of which have simultaneously or successively produced the loss. The liability in such cases has to be determined by the legal maxim of Proximate Cause (*causa proxima non remota spectatur*). The definition of Proximate Cause is—The active efficient cause that sets in motion a train of events which bring about a result without the intervention of any force started and working actively from a new and independent source." The law concerns itself with identifying the dominant, effective and proximate cause to the exclusion of all other causes that are too remote. Some court cases in this regard are interesting. In one instance, there was a fire in a factory. The fire damaged a wall of the premises to such a dangerous extent that the local authorities in the interest of public safety ordered it to be pulled down. During the work of demolition the wall fell on an adjoining building and damaged it. The court held that the wall which caused the damage fell in consequence of the injury it had sustained by the fire and therefore, although the wall was the instrument of damage, the fire was the proximate cause. In another instance, a similar wall which was damaged by fire, remained standing for several days and thereafter a storm brought it down, causing damage to the adjoining property. The court held that the proximate cause of damage to the adjoining property was not the fire but the storm and the negligence of the owner in not securing it properly to prevent its causing damage to the adjoining property. In the former case, the fire still continued to be an actively operating source of damage, whereas in the latter case, the fire had spent itself and it required the intervention of a fresh event to produce the loss, which, but for such intervention, might not have occurred.

The insurers too are bound by good faith. They are bound to place a proper interpretation on the terms and conditions of the contract and settle the claim with fairness and equity.

Losses incurred by the insured to check the progress of a fire or to save property are attributable to the fire, provided the steps taken are reasonable and bona fide. Property may be damaged by water used for the purpose of extinguishing the flames, but fire is regarded as the proximate cause of the loss.

Insurance policy forms the basis of the written contract entered into between the insurer and the insured. The insurer usually drafts the policy wordings. Hence, in case of any ambiguity in the meanings of the wordings in the policy, the court would interpret the policy in such a way so as to benefit (be to the advantage of) the insured.

Preparing for a Claim

When the loss is caused by an insured peril, the onus of proving that the loss was so caused is upon the insured. According to common law, the onus of proof is upon the insurers if the loss was caused by an expected peril. However, the wording of the policy may be so drafted that this onus of proof too may be shifted back to the insured. When a breach of condition is alleged, the onus of proving it is on the insurers. In case of life insurance, Section 45 of the Insurance Act makes it very difficult for the insurer to impugn the insured on grounds of breach of certain warranties after the expiry of two years since the inception of the insurance policy. Death by suicide also gets covered after one year of inception of the Life Assurance Policy. If a person has not been heard of for seven years by those who would naturally have heard of him had he been alive, there is a presumption (Indian Evidence Act) that he is dead. Under such cases the court may, on the application of his heirs, pass an order declaring the life assured might be presumed to have died. When such an order is passed, a claim would lie under the life insurance policy. The burden of proving that he is alive is shifted to the insurer then.

The principle of indemnity ushers in the requirement of proper loss assessment (of property insurance claims). The simple losses of small amounts are usually assessed by officials/staff of the insurance company. Other losses are assessed by independent professionals known as Surveyors having licenses granted by an appropriate authority under the Insurance Act. Independence of Surveyors is important to have a fair and unbiased assessment of the loss. Surveyors also have to decide the depreciation to be deducted in case of used property (building, plant and machinery, vehicles etc.) on account of gradual wear and tear in course of use, so that the insured is not placed at a better position than before the happening of the loss. This practice of deduction of depreciation on old properties while settling claims gives rise to a question in the minds of the insureds. The premium is always charged on the cost of new item (other than motor vehicles) and not on the depreciated value of the item. The insured feels that this is illogical. They often contend that the premium too should be calculated on the depreciated value. But while in case of replacements depreciation is being deducted, in case of repairs where cost of man-hours and machining expenses are claimed, no depreciation is admissible. So there is justification for charging full premium based on the cost of new items.

The insurance policy usually states that the choice of the manner of the indemnification of the loss is of the insurers. The insurance company may pay the value of the property at the time of the happening of its destruction or the amount of such damage or at its opinion reinstate or replace such property or any part thereof. This condition does not allow the insured the right to demand a manner of indemnification of the loss as per his choice.

At times it happens that the same subject matter of insurance is insured under two different insurance policies against the same peril. In claims arising under such circumstances, both the policies would be invoked to jointly contribute to indemnify the insured in accordance with the principle of indemnity. This is known as contribution. At the other extreme, if it is found that the sum insured is not a true representation of the amount at risk, and the cost of the subject matter of insurance is higher than the sum insured under the policy, the insurers will pay the loss in the same proportion as the sum insured bears to the actual cost of the item (Average Clause).

The insurance company may pay the value of the property at the time of the happening of its destruction or the amount of such damage or at its opinion reinstate or replace such property or any part thereof

After the insurer executes its promise regarding indemnification of the insured for the loss, the insurer attains all the rights erstwhile being enjoyed by the insured with respect to the item damaged. By this

principle of subrogation, the insurer may recover such amounts from a third person who could be culpable for the loss. This method of recovery from persons liable for an accident/loss has not been rigorously practised in this country. The probable reason being that the insurance companies are government-owned and the management is indifferent about the profit and loss accounts of the companies. But insurers abroad devote a great deal of their time and energy to recover such amounts by way of subrogation of the rights and privileges of the insured.

Law permits assignment of the benefits under insurance policies. In case of life insurance policies, assignment of the benefits can be done any time during the currency of the policy, while in property insurance policies, assignment can be done after a loss leading to a claim has occurred.

After a claim has been made, the sum insured under the insurance policy gets reduced by the amount of the quantum of the claim unless it is reinstated by payment of an additional premium.

If, after the occurrence of a loss, it is found that an item damaged had not been included in the policy, though it appears from *prima facie* evidence that the insured had intended to get the item insured, but on account of some error on the part of the insurer, it had not been included (possibly due to typographical error), the officer of the insurance company may issue a post-claim endorsement to cover that item after obtaining permission from the appropriate authority.

Insurance is a financial service. It falls under the purview of Consumers Protection Act. The Consumer Forum accepts complaints from the aggrieved insureds and decides such cases. Besides, the government has been setting up numerous Lok Adalats for speedy disposal of such cases. In those cases where the insurers have admitted the liability and the dispute is only regarding the quantum of the liability, both the parties may resort to an Arbitrator for amicable settlement of the case in lines with the Arbitration and Conciliation Act.

In the Insurance Policy Schedule there is no provision for payment of interest in case of delay in settlement of claims. This becomes a matter of concern for the insured in case of large claims, which because of their very nature, require lengthy periods for the surveyors to prepare their assessment reports. Then the claim processing has to take place at several offices like Branch Office, Divisional Office, Regional Office etc., before reaching the competent authority for final approval. Considerable time is taken at each of these rungs, and it is not uncommon for more than one year to elapse in this process. However, there is a provision of On-Account Payment of up to 75% of the claim amount before the final settlement of the claim under certain circumstances. With the liberalization of the insurance sector under the tutelage of IRDA, enhanced competition would surely improve the scenario from the perspective of the insured. ■

Insurance falls under the purview of Consumers Protection Act. The Consumer Forum accepts complaints from the aggrieved insureds and decides such cases

Legal Issues

By
Ruchira Kumaramangalam and Saurabh Awasthi
DSK Legal, Advocates and Solicitors
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An insurance policy compensates the policyholder against the financial impact that can arise following loss, damage, destruction of the property, health or life. The policyholder can only make an insurance claim if there has been a loss of the subject matter of the policy.

Insurance claims are settled in accordance with the terms and conditions of the insurance contract entered into between the policyholder and the insurance company. The settlement of claims plays an important role in generating satisfaction among policyholders and at the same time ensuring the accuracy and impartiality of the information provided by the policyholder and the insurance company at the time of settlement of the claim.

An insurance policy compensates the policyholder against the financial impact that can arise following a loss, damage, destruction of the property, health or life. The policyholder can only make an insurance claim if there has been a loss of the subject matter of the policy. Also, claims are settled depending on the measure of indemnity, which is decided at the time of procuring the policy. Both the parties to the policy are expected to observe good faith and disclose all relevant material information relating to the subject matter of the policy. The person insuring the subject matter be it, property, health or life must have some insurable interest in the subject matter.

Process of claims settlement

The process of claims settlement in India is illustrated in Figure 1.

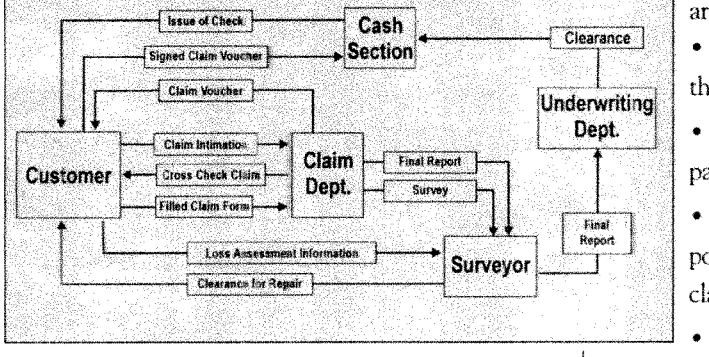
The submission of the relevant documents forms an integral part of the process of claim settlement in India. The documents required to be submitted with respect to an insurance claim include *inter alia* the following: Details of the insurance policy; Claim form issued by the insurance agent or the insurance company; The original insurance policy document; Intimation to the insurance company in writing; Estimate of loss to the insurance company.

Upon submission of the documents, the surveyor/company official would verify the documents and prepare an independent report on the assessment of loss/details of death. Further, the insurance company after checking the papers shall settle the claim as per the terms and conditions of the policy.

If the claim is processed or settled by the insurance company, then the insurance company or the insurance agent issues the discharge form. However, if the claim is denied by the insurance company and there is a dispute then, the policyholder can take the following steps:

- There are complaint cells usually functioning at the officers of the insurance company. The policyholders can send their written complaints to these offices.
- The policyholder can ask the insurance company to identify specifically the clause of the contract on which they rely for refusal of claims.
- If the insurance company claims that the policyholder has breached the policy, the policyholder may check the policy to see if there has been a breach as per the terms of the policy.

Figure 1: Claim Settlement



- Under the law, an insurance company has a legal obligation to inform the policyholder about the restrictions in the insurance policy. This must be done before the policyholder signs the application and the policy is issued. This means that the policyholder must be given a copy of the policy and the terms of the policy must be clear and unambiguous. If these preconditions are not met it may be possible to retain coverage under the policy.
- In case the claimant is dissatisfied with the decision of repudiation of claim he can approach the claims review committees comprising of senior officers of the insurance company for review of claims objectively.

Regulations governing claim settlement in India

The primary regulations governing the insurance in India are the Insurance Act, 1938, the various regulations and notifications issued by the Insurance Regulatory and Development Authority (IRDA), from time to time. In exercise of the powers conferred by the Insurance Act, 1938, the Central Government by notification, has framed the Redressal of Public Grievances Rules, 1998. These rules apply to both life insurance and general insurance policies. The said rules provide for the appointment of an 'ombudsman' who is conferred the powers to adjudicate and provide redressal in respect of public grievances, in particular for expeditious settlement of personal insurance claims. The range of issues over which the ombudsman is conferred powers to adjudicate are as follows:

- Any partial or total repudiation of claims by the insurance company.
- Any dispute in regard to premium paid or payable in terms of the policy.
- Any dispute on the legal construction of the policies insofar as such disputes relate to claims.
- Delay in settlement of claims.

However, no complaint to the ombudsman shall lie unless the policyholder has made a previous written representation to the insurance company and the insurance company had rejected the complaint, or the complainant had not received any reply within one month after receipt of the complaint by the insurance company, or the complaint is made not later than one year after the insurance company had rejected the policyholder's representation.

In addition to the above referred complaints, the ombudsman is empowered to receive and consider:

- Any total or partial repudiation of claims by the insurance company;
- Any dispute with regard to premium paid or payable in terms of the policy;
- Any dispute on the legal construction of the policies insofar as such dispute relates to claims;
- Delay in settlement of claims;
- Non-issuance of any insurance documents to customers after receipt of premium.

If the insurance company rejects a policyholder's claim or fails to reply to it within one month, then the policyholders can take their complaint to the ombudsman provided they do so within one year of the insurance company's rejection and they have not commenced formal proceedings with regard to their complaint. The ombudsman's ability to make awards is limited to the actual loss suffered by the policyholder, subject to a limit of Rs. 20 lakhs.

A High Growth Market

Bancassurance has been a success story in Europe, where banks account for 20% of the market share in UK, Germany, Spain, Sweden, Denmark and France. International experience suggests that the salesforce of banks have a productivity that is three times that of the direct salesforce and enhanced customer retention.

With a network of over 400 agents, Royal Sundaram views agents and brokers as being an important aspect of marketing in the Indian insurance scene. The Company perceives intermediaries such as banks, agents and brokers as the drivers of its innovative products and contracts. Agents enable an insurer to reach into those parts of the country where—both geographically and otherwise—the reach might have been impractical. With agents working on behalf of insurers and brokers on behalf of the insured, they both enable the client to receive the best advice on the most suitable insurance products. They also bring professionalism into intermediary work and can reduce the workloads of the client and the insurer.

Innovative trends

The Indian insurance industry can look at adopting certain innovative trends in practice in the developed markets. The most prominent being distributing insurance as a commodity through new channels like supermarkets, shops and the Internet. Certain other trends include distributing insurance as a custom packaged solution, transparent processing and speedy delivery of service.

Challenges

Some of the challenges faced by the Indian insurance sector in evolving into a developed market include development of insurance by addressing the educational and awareness requirements on insurance as a protection mechanism, sound industry practices and a continued regulatory environment promoting development.

The Indian insurance industry is poised for growth, given its immense potential. In the next 10 years, we can expect to see several developments including entry of several more insurers—small, national, commercial and personal, removal of motor and fire tariff and easy purchase of insurance as a commodity. With increased use of technology in the industry, we can expect to see the development of the electronic insurance card, encompassing all data pertaining to the customer. ◘

A Brief History of the Life Insurance Segment

The business of life insurance in India in its existing form started in India in the year 1818 with the establishment of the Oriental Life Insurance Company in Kolkata. Some of the important milestones in the life insurance business in India are:

1912: The Indian Life Assurance Companies Act enacted as the first statute to regulate the life insurance business.

1928: The Indian Insurance Companies Act enabled the government to collect statistical information about both life and non-life insurance businesses.

1938: Earlier legislation was consolidated and amended by the Insurance Act with the objective of protecting the interests of the insuring public.

1956: 245 Indian and foreign insurers and provident societies taken over by the Central Government and nationalized. LIC formed by an Act of Parliament, viz., LIC Act, 1956, with a capital contribution of Rs. 5 cr from the Government of India.

The general insurance business in India, on the other hand, can trace its roots to the Triton Insurance Company Ltd., the first general insurance company established in the year 1850 in Kolkata by the British.

Source: www.ciionline.org

New Distribution Channels

By
Ian Watts
CEO
Tata AIG Insurance Company Ltd.
Mumbai

Given the geographical spread of India, managing the distribution process will be one of the biggest challenges that the new players will have to overcome. There is one truth in marketing and that is 'Different Consumers Approach Buying Differently'.

Unlocking the Indian insurance stable

At the turn of the century, the Indian insurance sector, once the domain of state-run insurance companies was open to private enterprise. The insurance sector opened up to private competition on December 7, 1999, with the introduction of the Insurance Regulatory and Development Authority (IRDA) bill.

The business of insurance is not new to India. It is been around for over a century. With the opening up of the sector, leading multinational entered the Indian market through partnerships with eminent Indian business houses. What was once a quiet business is becoming one of the hottest businesses today.

Tata AIG General Insurance Company Ltd. and Tata AIG Life Insurance Company Ltd. (collectively called 'Tata AIG') were formed as joint venture companies between the Tata Group and American International Group, Inc. (AIG). Tata AIG was one of the first companies to apply for the license to offer insurance services in India.

The great Indian insurance market

There are two factors that make India an attractive market for most insurance companies. First, of course, is the sheer size of the market. With a population of over one billion, out of which about 40-45% is the insurable population, India is clearly a market poised for growth. The insurance penetration as well as the size of the average cover is well below international averages, again providing a great marketing opportunity for the insurance companies.

Second, till about two years back life insurance in India was synonymous to LIC which did most of the category building effort. While LIC has done commendable work, there is still a great deal of scope for bringing in innovative products and distribution channels to tap this market.

Given the geographical spread of India, managing the distribution process will be one of the biggest challenges that the new players will have to overcome. There is one truth in marketing and that is 'Different Consumers Approach Buying Differently'. This is true as seen from product preferences of other industries and is especially true for insurance in India. Studies have time and again shown that insurance is bought because of convenience, product features, product placement, safety of funds, advice, and not the price.

While LIC has done commendable work, there is still a great deal of scope for bringing in innovative products and distribution channels to tap this market

Insurance companies in India will have to develop appropriate channels to tap this huge market as the core of insurance business hinges on an efficient distribution system.

New Distribution Channels

The players have started exploring new channels of distribution just the way the developed economies have done it in the past. Some of the new channels of distribution are direct marketing through a dedicated salesforce, corporate agents, bancassurance, work-site marketing, independent financial advisors (individual qualified agents), telemarketing, retail chains, Internet etc.

The new rules of the game

Traditionally, the life insurers have been banking primarily on the agency distribution force, while the general insurance business has depended primarily on the development officers. The private players are bringing with them international experience, new technology, new channels of distribution and of course, new products. The ground rules in the insurance business are being redefined. Even the existing public sector players are gearing up with matching strategies to face competition.

The new private insurers coming in with the liberalization of the sector are adding more channels of distribution in the Indian market parallel to the existing ones. The mantra is innovation and diversification. Distribution is more crucial for the life insurer which needs to have a mass retail base to minimize the chances of being adversely affected by any casualty.

In a span of little over a year, the private insurance companies have grabbed nearly 10% of the life insurance market and in general or in non-life insurance sector the private players have captured around 9% of the market share.

The Tata AIG approach

Tata AIG will follow an approach of having a balance between the traditional and new channels of distribution, as well as the emphasis on the urban versus the semi-urban/rural areas. It must be borne in mind that India is a predominantly rural country and will continue to be so in the near future. New players may tend to favor the 'creamy' layer of the urban population. But, in doing so, they may well miss a large portion of the insurable population. A strong case in point is the current business composition of predominant market leader—the Life Insurance Corporation of India. The lion's share of its new business comes from the rural and semi-rural markets.

In a country of one billion people, mass marketing may be a profitable and cost-effective option for gaining market share. The rural sector is a perfect case for mass marketing. Competition in rural areas tends to be lighter than that in urban areas. And the generally smaller policy amounts in rural areas may be more than offset by the higher volume potential in these areas in contrast with urban areas. Identifying the right distribution to harness the full potential of the vibrant and dynamic rural markets will be imperative. Rural insurance is an opportunity and not an obligation. A smaller bundle of innovative products in sync with rural needs and perception and an efficient delivery system are the two aspects that have to be developed in order to penetrate the rural markets.

The new private insurers coming in with the liberalization of the sector are adding more channels of distribution in the Indian market parallel to the existing ones

Agency

This is the main distribution channel due to the complexity of most insurance products. This tends to be the focus of most companies due to its past success as well as its ability to deliver the right advice. Although this channel can be expensive and a time consuming one, it will remain the largest for many years to come. In little over a year, we have an established salesforce close to 10,000 agents; the target for the year-end is 12,000.

Bancassurance

Bancassurance is a multiple distribution channel in itself. Put simply, the insurance-distribution can be made during a loan application process. The use of a

highly trained advisor with support from the bank is very important in the bancassurance channel. This is a very promising channel due to the large coverage banks have in India. We have a tie-up with HSBC for our bancassurance business. We are looking at opportunities for tying-up with many more banks in India.

Products: Products for this channel must match the distribution technique. The distribution can be made through a quick and convenient sale such as during a loan application process. Hence, a simple, straightforward product with the right amount of protection (e.g., loan amount) could be the right product. Banks act as a financial planning adviser.

Corporate Agents and Direct Sales Agents (DSAs)

DSAs provide a very wide reach in India. Some DSAs already distribute financial products such as credit cards, loans and even non-life insurance products. This is a very diversified channel. They are best served using similar approach—such as Direct Mail (DM) or Telemarketing (TM). This is a very promising channel but time and resource must be devoted to make it successful. We have a corporate agency channel, which handles our corporate agents and have tie-ups with 38 corporate houses.

Products: Products for this channel must again match the distribution technique. If the DSA has a simple clientele, then simple, straightforward products (e.g., return of premium term, single premium term and non-participating endowment all with simplified underwriting) are sufficient. However, more sophisticated clientele require the product range to be wide to match the needs identified during the sales process.

Non-Governmental Organizations (NGOs)

NGOs are non-profit organizations working towards a social goal. Normally a large NGO will work through several small NGOs and Self-Help Groups (SHG) and deliver their service down to the grassroots of the rural society. The distribution has to happen at the grassroot level through the SHG, as the average rural Indian finds a great level of comfort and security in dealing in groups. The rural population normally prefers monthly premium in line with the micro-finance repayments that they are used to. Tata AIG has tied-up with Bridge Foundation, an NGO which has an office in Bangalore for its rural initiative.

Products: The adherence to the main philosophy and the ethos of the NGO/SHG is crucial and hence customized products with social messages will work best. The products also need to be simple, easy to understand and easy to deliver. Underwriting needs to be limited and simple, so that policy issuance is not a long drawn out affair.

Direct marketing is one of the most successful channels of distribution in the developed economies. It is a great way to reach a large population

The social message of covering the lives of the wage earners of the rural population is extremely important, along with the continuation of the education of their children in case of a calamity.

Brokers

Insurance brokers are organizations who assess the complete insurance needs of the client and then work out back-to-back policies with insurers to give a complete solution to the client. The distribution strategy here is quite different since the broker will have access to multiple insurers. Ultimately the variety of policies and options and the levels of service given by different insurers will have direct impact on the market share and mind share of the insurer with a broker.

Products: The products offered at the broker-sales outlet will be a range of products with options spanning from several insurance companies. The broker's USP is financial planning and need analysis for his clientele.

The process of identification of risks as given in Figure 2 is ideal as it highlights the following three steps:

- Perception and identification of the loss producing event,
- Analysis of all operative perils and consequential hazards,
- Understanding of all consequential losses.

In identifying perils or risks involved in any operation—either micro or macro—'the risk manager', in the words of JA Dixon, "breaks down operation into component parts, a bit like a computer anlayst, to see what risk is inherent in each part and to see if losses can be prevented or reduced economically".

Who can identify the risk? We have seen in everyday life that a man closest to a risk, cannot perceive it just like a man who has seen the wood, cannot see the trees! An outsider can be better equipped to see a peril in the operation. This is the exact role of the risk manager, who need not be a chemist to identify a risk in the chemical plant, nor become an engineer in an engineering factory or an electronics expert in a computer factory. Expertise is necessary with a view to control or evaluate a risk but not in the basic identification.

Methods of risk identification

- Physical inspection
- Discussion with the operating people involved
- Production/System processes
- Number of employees and the nature and type of their work
- Raw materials used
- Flow charts

Once the possible array of risks are identified, then managing them becomes easy.

Evaluation of risks: Steps

Cost of the risk operating has to be found out by the risk manager with the help of all concerned, e.g., accountants, production engineers, etc. Risk evaluation will bring into limelight the financial quantum of possible loss and lead the way for:

- Cost of risk prevention methods,
- Adequate sum insured, if insurance is considered necessary.

Removal of risk

This can be achieved by segregation of units, if possible, by change-over to another less-hazardous or non-hazardous raw material, shifting of the complex itself, if the hazards present, threaten the lives and health of people by overcoming dependency on a single supplier, etc.

Reduction of risk

There are risks which can be:

- Improved
- Reduced in its impact
- Minimized or partially controlled

Reduction of risk is achieved by getting technical expertise from outside and building safety consciousness at all levels of management.

We, in Hindustan Lever, are proud to have accident-free and fire-free record in all our factories in the last five decades. This success is entirely due to the importance given to safe operations in the shop-floor and training in safety methods imparted to all operatives who are exposed to hazards. Safety and safe operations involve safety in access, working environment, systems, etc. The inspectorate of the TAC has also contributed in a large measure for the safety and reduction of fire and explosion risks through regular inspection of fire alarm systems, fire hydrant and sprinkler installations in risks.

In the *Handbook of Risk Management*, we come across a comprehensive table giving emphasis on risk reduction through loss prevention methods.

The installation or initiation of loss reduction or control devices will not mean complete cessation of all

risks. There will be always residual or catastrophic risks on which the company has to decide whether they are small enough which could be carried on or whether these risks have to be transferred (insured).

Assumption of risks

A corporate body can retain some of the acceptable risks by either not effecting insurance against such risks or by a process of self-insurance.

Running one's own risk, is achieved as a result of efficient balancing between:

- Cost of prevention, and
- Cost of insurance.

To take an example —is cover against flood, riot and strike necessary—consider it in the context of recurrent floods in the North Eastern belt of India? Is it not an insurable risk if the factory is situated near a river-bed with a history of flood during every monsoon?

Insurance against flood risk may be a better solution than removing the factory to a higher area with the resultant increase in costs of moving raw materials in and finished products out.

In self-insurance, a fund is created to which the losses are debited. Every year, the 'premia' is contributed into this fund. The scope of self-insurance will largely depend upon the organization's financial capacity to absorb possible losses. The financial guidelines have to take into consideration not only the maximum loss which could be absorbed within any one financial year but also the amount of losses that can be accommodated within the budgeted cash-flow at any point of time.

Self-insurance becomes necessary when the risks can be retained and when the insurance cost is high. Insurers generally rate risks on "class experience" basis, and an individual insured may find himself grouped in a class where the premia rates are high due to adverse claims experience contributed by the few resulting into a non-appreication of his own superior safety record.

Self-insurance also reduces the costs of running a corporate insurance department, insofar as fewer claims have to be preferred and fewer policies have to be paid for.

Self-insurance becomes the only alternative when there is no insurance cover available and where rigidity has set in by way of tariffs all around.

To sum up

- Small losses occurring in high frequency—retain under self-insurance
- Rare losses with catastrophic potency—transfer or insure .

Self-insurance can also be practiced in many other ways, e.g., by not repairing or replacing a damaged wall or a piece of machinery, by losses being absorbed as part of current operating costs, by diverting funds to meet losses as and when they occur from internal resources, by arranging loans purely on temporary basis from financial institutions.

Self-insurance reduces the costs of running a corporate insurance department, insofar as fewer claims have to be preferred and fewer policies have to be paid for.

Self-insurance is a factor to stay and practiced universally and will encompass in its range, an insured having one motor vehicle bearing an excess or deductible or a large corporate body running the risk of possible losses due to strike and riot risks.

Transfer of risks: Insurance

The role of insurance as the best method of risk transfer —apart from clauses in the contracts specifying and transferring risks on to the shoulder of the other party. Leave alone the compulsory insurances like the insurance against emergency risks and under the Motor Vehicles Act. Before insurance is effected, the risk manager is supposed to have gone through, carefully, the entire risk management exercise as outlined above. Insurance of assets and

liabilities then will become a well-organized, well-understood and well-conceived financial necessity.

Generally, in the past, the decision to insure or not to insure was subjectively based on tradition or fear. Tradition is that "it has always been insured", fear in terms that "we cannot afford to insure".

Before insurance is effected, the following questions should be asked and answered:

- What are the insurable risks that affect business?
- How likely are losses to occur from these risks?
- The probable cost of these losses to the insurers.
- The seriousness of the losses and the possible cost of losses.

If the above questions have been fully answered, one will be able to decide on:

- Whether insurance is necessary or optional
- Whether insurance cost can be incurred.

Role of risk/insurance manager

It all depends upon the person who is the risk manager. It is a service department —hence, absolutely necessary to tow a low key emphasizing and reminding but never chastizing or criticizing, however correct we are.

Insurance is a technical subject and nobody else is expected to know your requirements unless explained or communicated. Let us study an example:

- Unit –A consumer product, high turnover concern
- Insurance–Centralized Department
- Risk manager as a guide, friend and expert.

Consider as to whether visits to factories/units are necessary or can information questionnaires be sufficient?

What about compliance then?

It is needless to emphasize the aspect that responsibility and accountability are not over once the policy is secured.

'Risk management' in India is in its infant stage. But, its future role is bound to be remarkable as in controlling effectively the various risks that are bound to arise due to the speed of change at all levels, which the environment is passing through just now, will lay the success and basis for a better tomorrow.

Self-insurance becomes the only alternative when there is no insurance cover available and where rigidity has set in by way of tariffs all around

To conclude, in the words of Alvin Tofler (Future Shock)—"Change is essential to man, as essential now in our 800th lifetime as it was in our first. Change is life itself. But change rampant, change unguided and unrestrained, accelerated change, overwhelming not only man's physical defences, but his decisional processes—such change is the enemy of life".

It seems that the challenge is stupendous but worth accepting. ◘

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Statistical Glimpse of Insurance

Growth in LIC's Policies		
Year	No. of policies in millions	Sum assured in Rs. cr
1969-70	14.0	6348.1
1974-75	18.8	11852.2
1979-80	22.1	19242.6
1989-90	40.4	94823.2
1995-96	71.0	295758.0
1996-97	77.8	344619.3
1997-98	85.0	400747.9
1998-99	91.7	459201.04

LIC's Rural Market			
Year	No. of policies (Rs. lakhs)		
	Total	Rural	% share
1961	14.6	5.3	36.5
1970	14.0	4.6	33.0
1980	21.0	5.9	28.2
1990	73.9	30.5	41.2
1998	133.1	68.4	51.4

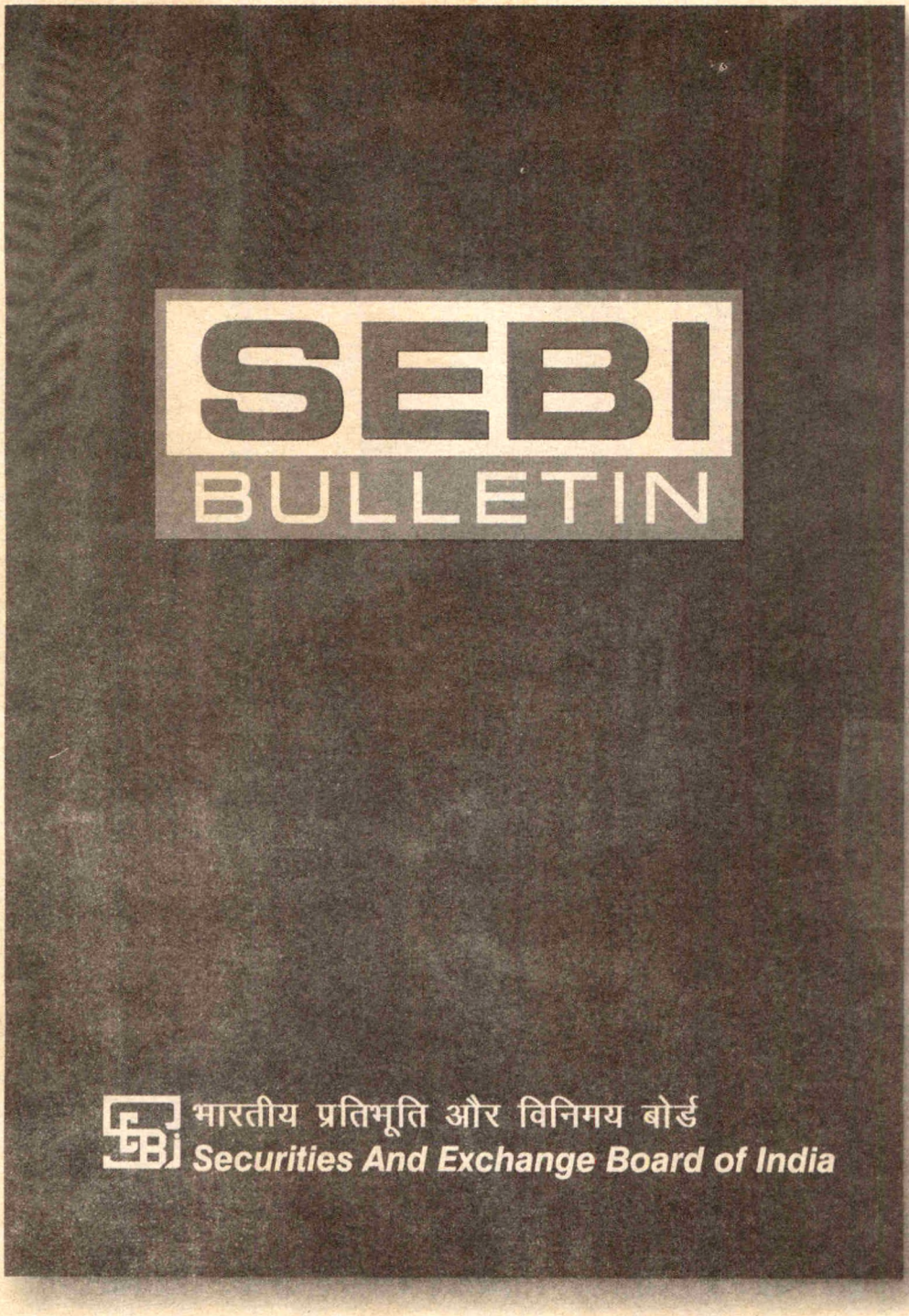
Growth in Life Funds	
Year	Figures, in Rs. cr
1969-70	1611.0
1974-75	3033.8
1979-80	5818.0
1989-90	23471.8
1995-96	72780.0
1996-97	87760.0
1997-98	105832.9
1998-99	127389.1

Sum Assured (in Rs. cr)		
Total	Rural	% share
598.8	182.6	30.5
1025.8	251.8	24.5
2733.1	603.8	22.1
23219.5	8086.4	34.8
63617.7	27550.7	43.3

Indian General Insurance Companies Performance										
	GIC		National		New India		Oriental		United India	
	1998-99	1999-2K	1998-99	1999-2K	1998-99	1999-2K	1998-99	1999-2K	1998-99	1999-2K
Volume of Business	1269.74	1399.89	1646.80	1715.76	2402.34	2697.19	1558.23	1742.19	1776.91	1914.54
Profit / Loss (-)	-101.63	-229.53	-212.85	-231.91	13.18	-177.98	-257.26	-298.50	-128.04	-276.63
Interest, Dividend and Rent Income (Net)	592.07	649.61	296.30	332.36	551.51	613.30	324.35	359.29	389.45	427.04
Net Profit After Tax	372.61	313.60	79.88	96.53	375.00	287.29	54.57	57.85	192.10	121.59

Growth at a Glance					
	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001
Capital and Funds	85,011	100,492	118,819	133,694	164,322
Investments	144,74	168,282	191,683	220,109	238,498
Total Assets	187,576	215,720	245,572	279,202	308,045
Technical Reserves	37,729	40,898	46,216	51,050	55,504
Gross Direct Premium	73,479	80,856	91,575	99,822	107,719
Net Premium Income	6,733	73,571	84,025	93,634	102,721
Investment Income and Profit Less Outgo	17,203	20,077	21,536	24,917	27,150
Profit Before Tax	10,919	16,236	14,670	11,526	7,292

Source: www.bimaonline.com



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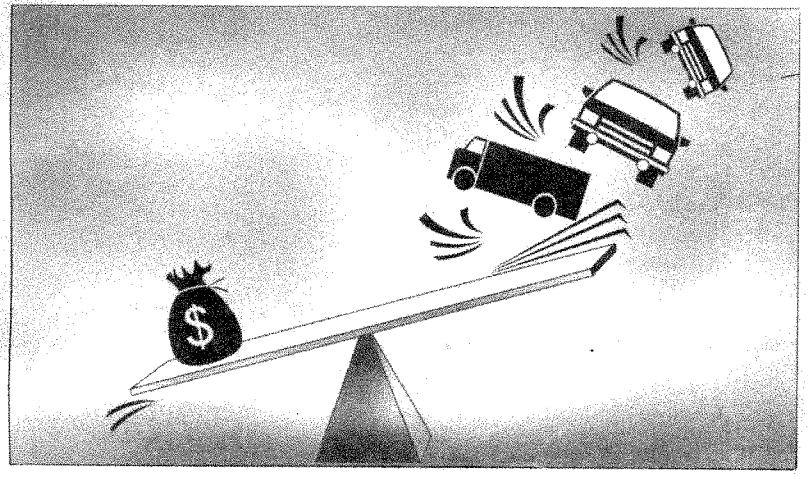
FIAT

Uncertain future

Fiat, Italy's industrial icon and the Agnelli family's 103-year-old legacy struggles for survival.



Fiat's story from riches to rags has all the ingredients of a classic case study of how an empire crumbles. The problems that led to the fall of Fiat are many, including insufficient product line up, poor quality image, overcapacity, mistaken strategy, unrelated diversification, restrictive labor laws and protectionist measures. Add to all this poor management and misguided investments; the result is a perfect recipe for disaster and Fiat today stands an example for this.

Fiat (Acronym for Fabbrica Italiana Automobili Torino) was founded in 1899 by a group of entrepreneurs under the leadership of Giovanni Agnelli, whose descendants still control the group with a stake of 30.5% in the group. Growing steadily and expanding its operations throughout Italy, Fiat had emerged as the most important industrial player in Italy. With total revenues of €57 bn and operations spread across 61 countries, Fiat is one of the largest industrial groups in Italy. The Group organizes its businesses in 10 different sectors with 1,063 companies that employ over 223,000 people, 111,000 of whom are outside Italy.

In fact, Fiat had become something of a national icon and the Agnelli family is akin to a royal family. For over half a century Fiat had a near monopoly in the Italian market and it had led Italy to the position of the fifth largest economy in the world. The group's interests are varied and cover automobiles, agricultural and construction machinery, commercial vehicles, metallurgical products, components, production systems, aviation, publishing and communications, insurance and services. Fiat Auto (FA), the flagship company of the Fiat Group, which contributes around 40% of the group's revenues, has been squandering money continuously for years now and is the major cause for sinking the whole group with it.

Plenty of problems

Fiat is reeling under the total debt burden of €5.8 bn ($5.6 bn). The burden was as high as €6.5 bn at the end of 2000 and has been reduced owing to some of the restructuring measures the Group has undertaken recently. Its domestic sales in Italy has shrunk by 17.8% while the overall Italian market fell by 5.9%. This is, in spite of the favorable tax breaks given by the government. Fiat's debt rating has been cut down to 'junk' by Moody's as on December 24, 2002. Its share price had touched a 20-year low in the same month. Fiat's shares have lost 80% of their value since General Motors bought its 20% stake in 2000.

For the year 2001, Fiat reported a net loss of €791 mn on total revenue of €58 bn; its first loss in eight years. While FiatAvio, Toro and Business Solutions drove the revenues, the net losses were attributed to a combination of contraction in operating margins, restructuring charges and a write down of the value at which the Group's insurance companies carry their securities portfolios. Then, Fiat embarked on an ambitious restructuring and relaunching plan. In order to increase its car sales it had sought the government to eliminate some automobile taxes on small and medium-sized environment-friendly cars. The strategy increased Fiat's sales marginally but helped its competitors more. The government decided to extend the policy, which was due to end in December 2002. The financials of Fiat looked no better for the nine months ending September 2002. The group as a whole had made a loss of €1,143 mn before taxes as against a profit of €855 mn during the same period. Fiat Auto's operating loss for the

period was €1163 mn as against an operating loss of €117 mn for the same period in 2001. In fact, except for Toro and Fiat Avio all the remaining segments either reported losses or lesser operating income when compared to the same period in 2001.

Traditionally, Italy has been Fiat Auto's largest market. The main brands of Fiat include Fiat Doblò, Fiat Stilo, Alfa 147, Lancia Palio etc. The group ensured that it remained a dominant player in the Italian market by ensuring that the government created a protectionist environment. By the 1990s, Fiat Auto had become a dominant player in the European market. FA's specialty had always been small cars and sports cars and it did not really expand on its product line. Italy as a nation did not focus on research and development and Fiat was no exception. But lack of proper investment in R&D hit the group severely when the Italian market opened up for foreign players. While its models looked aged and ranked lower on quality, nimble players with better products eroded its market share.

Today, Italians prefer a Volkswagen or a Renault to a Fiat. FA's market share in Italy fell from 60% to 30.3% in a decade. In 2001, Fiat made a desperate attempt to garner the market by its Stilo Saloon. However, that proved to be a dampener; consumers opined that Stilo came with too many technical features they did not really need and had a higher price tag. Fiat is now coming up with a much simpler version of Stilo, which it expects would appeal to the cost-conscious Italian consumer. In addition, Fiat had withdrawn its Bravo and Brava models much before the launch of Stilo, which adversely affected the total sales. Fiat Auto reported a decline of 10.8% in its unit sales in 2001 owing to the reduced demand as well as the economic and financial crises in Argentina and Poland. As of now its capacity utilization is lesser than what is required to make profits.

Fiat's problems started a long time ago and are mainly related to product (poor quality levels), scale (not big enough) and too much dependence on one market

Strategies backfired

A shallow product line of FA is only one of the many problems that plague the Fiat Group. In the decade of the 1990s, Fiat had burnt its fingers with a number of unrelated and costly acquisitions. In fact, these expensive acquisitions account for most of Fiat's $5.6 bn debt burden. Consider the case of Case New Holland (CNH), maker of agricultural and construction machines. CNH was created in 1999 when Fiat acquired Case, an American company for $4.6 bn and combined it with its own New Holland Business. CNH accounts for half of Fiat's total debt. CNH has brought about cost savings by cutting large number of plants but that has not done much to improve the financials of Fiat. CNH is today one of the better performing Fiat divisions along with FiatAvio, the Avionics division and the prestigious Ferrari. Analysts opine that Fiat bought Case expensively at the top of the cycle and that the deal was wrapped in a hurry for the fear of losing to a rival, John Deere. The result was that Fiat ended up with a huge hole in its finances.

Another strategy that really backfired was Fiat Auto's foray into emerging markets. FA had established big manufacturing operations in Argentina, Brazil and Turkey. With the economies of these countries going for massive downward curve, the prospect of revenues was nowhere near. The operations meanwhile have consumed enormous amounts of cash. Realizing this in 2001, Fiat decided to cut down the presence of Fiat Auto and Iveco in Argentina and targeted the Chinese market instead.

> **"Fiat really hasn't got many options —it is owned by the banks pretty much. The Italian Government can't really do much to bail it out thanks to Brussels and GM is increasingly unenthusiastic.**
>
> **Graeme Maxton**
> *Economist and Co-founder of autoPOLIS*

Some of the acquisitions, though unrelated were extremely profitable businesses, which can be sold to save Fiat now. Acquisitions that fall into this category are Toro, Italy's third largest insurer and Montendison, an energy-to-chemicals conglomerate that is Italy's biggest private power producer.

Messy management

It is believed that most of Fiat's problems stem from poor management. Paolo Cantarella, the former chief executive of Fiat, who stepped down in June 2002 probably presided over the major damage of the group. Graeme Maxton, Economist and Co-founder of autoPOLIS, observes, "Fiat's problems started a long time ago and are mainly related to product (poor quality levels), scale (not big enough) and too much dependence on one market (mostly Italy). They could have fixed a lot of these a decade ago but for the other problem—poor management. Several other European car companies had similar issues at the start of the 1990s and addressed them before the European market liberalized. Cantarella and his team

chose not to." Fiat Auto had lost $2.6 bn in four years between 1998 and 2002 under Cantarella's 'aegis'.

In less than a year since his departure, situation at Fiat was anything but stable, especially at the top. Gabriele Galateri, a trusted lieutenant of the Agnelli's was brought in as the Co-Chief Executive to Paolo Fresco, the Chairman of the group who was also acting as the Chief Executive since Cantarella left the organization. Expectations were high when Galateri took over but within a short span of five months he resigned without changing things much. It is believed that the main reason for his departure was the excessive intervention of the Italian Prime Minister, Silvio Berlusconi in the management of Fiat.

Auto businesses have longer gestation periods and require strong, continuous leadership to turnaround the company. If a leader has to orchester a turnaround like what Lee Ioccoca did at Chrysler he needs to be given enough time, a free hand to implement radical solutions and unquestioned support of the Board and the creditors. But Fiat's top management is nowhere near to granting such freedom to the top leadership. Commenting on Galateri's not so fruitful tenure, Maxton says, "There is a certain stasis at the top of Fiat right now—the company knows that it needs a radical solution, but no one wants to take it. That must have been an impediment." He further avers, "But, to be fair, you can't turnaround a car company in anything less than five years, not five months. That's how long it will take to turnaround Mitsubishi and Chrysler and it would have taken about that to turnaround Nissan properly. Car companies have very long product cycles and masses of investment..."

The restructuring plan attempts to minimize Fiat's dependence on the Italian market and also ramps up investment in R&D that would modernize the Fiat stable

Rescue plan

Fiat had devised a rescue package to put itself on track. The plan proposed massive lay-offs and closing down of plants as well as increasing the product line and selling off assets to clear the huge debt that has piled up. The restructuring plan attempts to minimize Fiat's dependence on the Italian market and also ramps up investment in R&D that would modernize the Fiat stable. As per the plan Fiat will require capital expenditures and R&D outlays totaling to €2.5 bn a year from 2002 to 2005. By then, the company claims that the average age of Fiat Auto's models will be less than four years, the standard at top industry competitors. FA also expects to reap cost savings through its industrial alliance for component development with GM. In addition, FA also attempts to address the deficiencies in its distribution system.

Perhaps the most controversial part of the plan is the lay-offs. In the light of severe opposition from the unions, Fiat sought government's help to tackle this issue. A status of business-in-crisis will make the Special Temporary Lay-off Benefits Fund to these employees. Fiat promises to rehire these employees once its new models are on full-scale production. The restructuring plan ran into rough weather with tough opposition from the unions. The government of Italy was forced into the discussions and acted as the mediator. A final agreement has been signed on December 5, 2002, which was proposed by the government.

The plan provides "social shock absorbers, tools for an active labor policy and support for research and sales." Adopting the plan Fiat temporarily 'assigned' 5600 employees at various Italian plants to the 'special temporary lay-off benefits fund'. The plan aims at bringing in a cost savings of €1 bn.

The restructuring proposal was also approved by Fiat's major banks, IntesaBCI, UniCredito, Capitalia and Sanpaolo IMI who have extended a mandatory convertible loan of €3 bn ($3.1 bn) to Fiat. If Fiat fails to repay the bank loan, then the banks will have the option to convert their loans into 30% equity stake in Fiat, an alternative that the banks are keen to avoid.

Fiat had committed to reduce its debt below €3 mn by the end of 2002. In a failed attempt to meet that target, Fiat has already sold a 34% share of its Ferrari holding to Mediobanca for $1 bn. The Italian premier has an indirect stake in Mediobanca. Fiat has also sold its 5.6% stake in GM, 32 million shares which it had acquired in 2000 to Merrill Lynch for $1.16 bn. In addition, it has also disposed off with the consumer-financing arm Fidis.

One ray of hope from the point of FA is the put option it had sold to GM in 2000. GM had acquired 20% stake in Fiat Auto and the right to buy the remaining 80% in January 2004 if the conditions are met. While this could be the best option of disposing Fiat Auto, neither side is really excited about this. This option of selling itself to GM is seen as a major slide to the national pride of Italy and the Prime Minister has publicly stated that he would ensure that Fiat remains as Italian. When it comes to patriotism, even the Agnellis are not far. Shrewd patriotic businessmen that they are, floated a separate entity Fiat Auto SPA, keeping Ferrari, Fiat's most popular brand out of the reach of the Americans. On the other hand, GM has its own reasons for not wanting to buy Fiat Auto. The loss-making unit could prove to be a major drag and GM seems disinclined to exercise its option. GM has actually

written down its investment from $2.4 bn to $220 mn recently.

Political time bomb

The rescue plan approved by the banks and the company to restructure Fiat demanded massive lay-offs and it had become a major deadlock when it comes to implementation. Workers took on agitation and with unemployment in Italy being one of the highest in the European Union, the government could not support the lay-offs. In addition, the fact that Fiat is the largest private sector employer (with over 95,000 employees) in Italy and one that has offered security to generations of people could not be undermined and the government could not afford to allow the lay-offs in spite of Fiat's promises that it was only temporary. The issue's political sensitivity was well estimated through the fact that the Italian parliament had questioned Fiat's top brass.

The issue had blown up to be a politically sensitive affair with Berlusconi indicating that in no subtle terms he would do the needful to ensure that Fiat remained Italian. However, Italy being a member of the European Union cannot go for a government bailout, a move that is also against the spirit of free markets. In fact, this political imbroglio is only delaying things. Graeme Maxton points out, "In one sense he has muddied the waters by making it clear that the Italian Government is willing to intervene. Which it shouldn't in my view and probably won't be able to if Brussels has anything to do with it." Maxton further clarifies, "He (Berlusconi) also appears to wish for a nationalistic solution, perhaps naturally. But it is exactly that sort of thinking that got Fiat into this pickle in the first place."

Turning a blind eye to changing market realities would never sustain a company even if it were a 103-year-old giant

With too many parties vying to have their say, no concrete solution is being implemented and with each passing day Fiat is nearing its inevitable death knell. Graeme Maxton concludes, "All this messing about by these bankers, the Agnelli's and the government are just delaying the implementation of what is the best solution—the closure of Fiat's car business."

The savior?

The latest development in the Fiat saga is Roberto Colaninno, the former head of Telecom Italia, who has expressed his intent to takeover Fiat. He has his own version of a rescue plan, whose outlines are as follows. He wants to pump in an amount of $1.4 bn from his pocket into Fiat and plans to raise the remaining cash from the sale of Fiat's assets. In return he wants a stake in Fiat, which would make him the largest shareholder and also wants to takeover the management of Fiat. Berlusconi has subtly supported the plan by appreciating the fact that Italian businessmen are showing interest. The Agnellis, it is believed, are not dear friends of Colaninno, who had outbid them in the power struggle for Telecom Italia and the bankers of Fiat are neither too happy about Colaninno's intentions. Fiat maintains that it has not received any intimation from Colaninno and the official rescue plan remains to be the one that has to be approved by the board and bankers. Even if one assumes that Colaninno would take over, it might be a long time before any tangible development in Fiat's is seen.

Fiat is to be blamed for its present state of affairs. Turning a blind eye to changing market realities would never sustain a company even if it were a 103-year-old giant. Graeme Maxton says, "This is all something of an Italian pantomime, which I'd have a lot more sympathy for, if Fiat's problems weren't so self-inflicted. I wrote an article in 1994 for part of *The Economist* highlighting the company's problems and I remember that the only response that I got was a copy of it from Cantarella with the bits he didn't like underlined in red. There was no factual error; he just didn't like the company's problems being highlighted. That sort of thinking is the root of this problem."

Future options

So where does Fiat go from here? One option could be it would be sold out to GM and be integrated into the European operations of GM. But that scenario seems highly unlikely given the unwillingness of both the parties. Graeme Maxton maintains, "Fiat really hasn't got many options —it is owned by the banks pretty much. The Italian Government can't really do much to bail it out thanks to Brussels and GM is increasingly unenthusiastic." While the option of government bailout is ruled out, the takeover by Colaninno could be a reality. But to what extent he will be successful is doubtful.

Maxton predicts, "I see something like what happened to Olivetti—10 years of gradual decline—with parts of the business going to GM, much of it closing and a lengthy howl of agony from Italy. It is sad and very unfortunate but it is the result of poor management, more than anything."

This is not the first time Fiat has found itself in trouble. It had been on the brink of bankruptcy in 1980, when Cesare Romiti saved the group by drastically restructuring the operations. Who knows, it might just get lucky this time around!

D G Prasuna

Reference # 1-2003-02-07

Agenda for Union Budget 2003-04

It's the budget time again; now the focus is on the Finance Minister (FM), Jaswant Singh's maiden budget. The year 2002 poses a horde of challenges like global slowdown, burgeoning fiscal deficit, outstanding internal debt of the Center and State Governments etc. However, on the positive side, healthy external financial position, softening of inflation rate which is resulting in lower interest rates are in store. Given this kind of an environment, what are the expectations from the budget?

The FM is expected to chalk out a path for achieving its target of a desired growth in GDP (8%), although this has been widely criticized, the Government is expected to remain obstinate about the target. The FM is of the view that topmost priority will be given to growth and fiscal deficit. No surprises! This was promised during the last five budgets but the target has remained unachieved.

However, there is one area where Jaswant Singh has made a proposal that can probably be implemented and bring about credibility to the Government's policy measures. He has declared that, unlike in the past, the budget exercise will be fully transparent except, of course, for a few strategic areas. He continues with his promises, "We are very clear in our mind, we must enhance production, increase GDP, put more money in citizens' pockets and housewives purses... Growth through reforms is Government's priority." And all this is to be achieved not by strict control on non-plan and administrative expenditures but by pushing reforms.

Given the compulsions of a coalition government, it, however, looks like a difficult target. The case in point is disinvestment program. So far the government has not been able to make much headway on this front. The question is not whether disinvestment is good or bad; it is whether ministers can be allowed to pursue their own agendas to the detriment of the stated policies of the Government. Implementing the recommendations on direct taxes made by the Kelkar Committee would have been another big announcement by the FM. Above all, the coming general elections in mid-2004 may compel the FM to present a soft budget as populism overtakes pragmatism. So it is certain that in his first budget, the FM will offer substantial concessions to the middle class.

To get an expert perspective on the Union Budget agenda, *Analyst* invited Susmita Dasgupta, Deputy Chief Economist, Joint Plant Committee, Ministry of Steel, Dr. A S Harish, Senior Manager, The Vysya Bank Limited, and Sudipa Majumdar, Economist and Proprietor, Newel Consultants to participate in the debate.

N Janardhan Rao

Susmita Dasgupta

Deputy Chief Economist
Joint Plant Committee
Ministry of Steel, Government of India

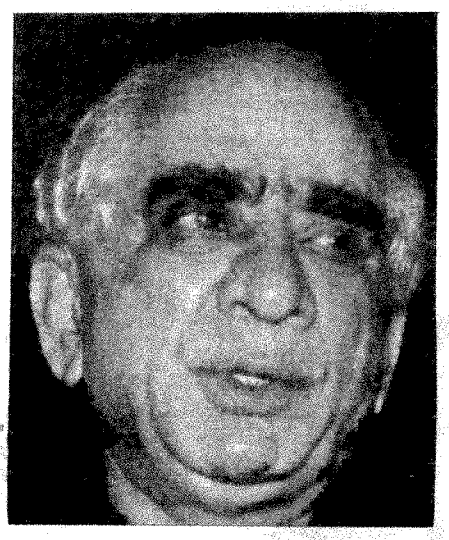
The agenda for the Union Budget 2003 would be pretty much similar to the concerns of the previous year's budget. The two conflicting concerns of the government would be to generate more revenues for itself and spend more on growth. The withdrawal of the State from economic activities has led to a contraction in private investments that has in turn led to the contraction of government revenues by way of taxes. There is no way that the State can return as the major spender in economic activities and given the shyness of the private investors it is likely that the economy will remain in its contractionary phase.

However, private investments are improving because the core sectors like coal, power, steel and cement have all improved. There is a likelihood of foreign investments coming in a little more than the usual trickle.

The major tasks before the Budget 2003 are as follows:

- Better tax compliance and wider tax base for the direct taxes that include both personal, professional and corporate income tax. There would be less scope for the increase of indirect taxes in view of the rising competition due to globalization. The capture of NRIs on the tax net is also a step in this direction.
- States' finances must be boosted especially now that the states have defaulted on account of the Plan expenditure and not on the non-Plan expenditure. Therefore, the performance of the states must be boosted. The Union Budget being a fiscal statement of expenditure and revenue would probably not be in a position to comment on this, but nonetheless it will concern itself on ways and means to boost up the finances of the states so that the expenditures on the plan heads are possible.
- The government has taken a giant step towards globalization in allowing Indians to invest abroad. This might help boost the Indian capital markets or at least the mutual funds and the debt markets.
- The government will concentrate on the boosting up of the bank's finances by allowing them to recover their non-performing assets. Major sectors such as textiles and steel where the proportions of defaults are the highest might see the setting up of renewal funds.
- Inflation that otherwise took care of the government and the corporate debts would now continue to remain at 3% and hence leave debts where they were. Interest rates would have to decline in order to compensate for the decline in inflation. This would mean loss of revenues for the banking sector and the budget must make provisions to boost up the financial institutions.
- The curtailing of government subsidies is not likely to happen in view of the general elections drawing closer. The government is likely to continue with the farm subsidies although subsidies from higher education, electricity for agriculture and municipal water supply are likely to be withdrawn.

The government has identified the construction sector as one that accelerates the economy and would grant several tax incentives for the prospective property owners

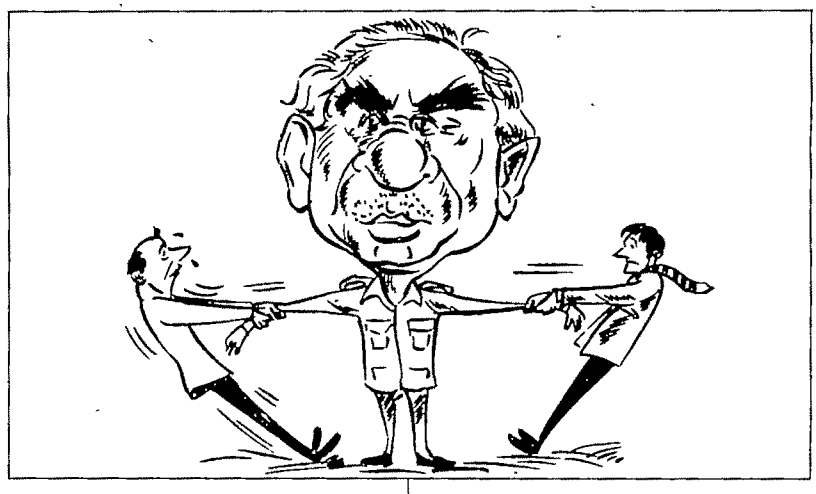


A budget being merely a statement of revenue and expenditure by itself has little capabilities to boost demand. What the budget can do and would do is create incentives for the people to spend. The lower rates of interests on savings are likely to increase savings rather than reduce it. The wider tax base would also depress spending. The government has identified the construction sector as one that accelerates the economy and would grant several tax incentives for the prospective property owners. The government would also see that more and more of house construction come up in the rural areas under the housing scheme for the weaker sections. This would not only boost economic activities, it would create vital demand for infrastructure spending such as water supply and power and generate assets in the economy. Although this might not create demand in the short run it would create good demand in the medium-term.

Once again we must observe that the budget has very limited powers to generate growth. The poor would have less subsidies and less work and hence less wages. The best medicine against poverty is the creation of work and the budget would have nothing favoring the creation of employment. The budget is unlikely to be beneficial to the poor.

Dr. A S Harish

Senior Manager
The Vysya Bank Limited



It is budget time again and the Union Budget for 2003-04 poses a lot of challenges to the Finance Minister in view of the global slowdown, inflexible government cost structure, high fiscal deficit, outstanding internal debt of the Center and States at around 70% of GDP, structural rigidities in the interest rate structure, electoral compulsions since some important state assemblies are due for polls followed by General Elections in 2004 and more importantly this is technically the last full scale budget for the present Government. On the positive side, healthy external financial situation, accelerating pace of disinvestments, softening of inflation resulting into lower rate of interest, may facilitate the budget process. Nevertheless the pace of forex inflows and its impact on other macroeconomic factors particularly interest rates is presenting both an opportunity and challenge. Now we are in an open economy and the threat of imports is enough to keep prices under check. In fact, the Finance Minister's mid-year review has already outlined the broad policy directions on key issues.

An investment/ expenditure should not be financed by fiscal deficit, if the returns do not commensurate with the cost incurred

Given this macroeconomic backdrop, the following are some of the suggestions:

The expenditure comprising of interest payments, defense expenditure, wages and salaries make up the bulk of government expenditure. They are in the nature of a fixed component and cannot be cut so easily. We should realize that the options are limited. The focus should be on reducing non-productive expenditure. The allocation of resources to accelerate the growth in the economy should be based on proper market-oriented considerations. An investment/ expenditure should not be financed by fiscal deficit, if the returns do not commensurate with the cost incurred. Otherwise, the higher fiscal deficit arising out of non-market oriented considerations would decelerate the growth. This argument is to be seen in the context of suggestions that the fiscal deficit should actually rise to ensure more capital expenditure in the economy. There is nothing wrong with running a fiscal deficit if the investment is at least fetching moderate returns.

The execution of market-oriented economic policies, however, should go hand-in-hand with measures that strengthen the social sector to overcome poverty, illiteracy, malnutrition, and ill-health. In developing countries, such as India, with massive illiteracy and underdevelopment of infrastructure, government must continue to have an important and crucial role in creating the necessary conditions for growth through investments in areas, such as, education, health, water supply, irrigation, infrastructure etc.

The industry associations may plead for retaining high tariff rates and small-scale industrialists seeking to maintain *status quo* on the issue of SSI reservation, the trade union leaders oppose amendments in labor laws and demand an end to privatization. The current peak level of customs duty is at 35%. Rahul Bajaj, in the past, has felt that if customs duties continued to be brought down, "one day all of us will become traders". The argument is that the Indian industry is hamstrung by factors such as high power tariffs, interest rates, infrastructure and transaction costs. These make the Indian industry, it is argued, uncompetitive in an era of rapid globalization and hence the customs duty should be retained at the current level. The environment is conducive today on the issues of interest rates, infrastructure and transaction costs. Besides, the companies have become cost-conscious and a recent study by Crisil revealed that corporates have become working capital efficient. The corporates have woken up and are taking on the competition rather than clamoring for more protection.

Many corporates have started appreciating that more protection signifies the inability of domestic industry to compete with the best in the world and encourage underperformance.

As the economy is increasingly getting exposed to global competition, Indian industry as a whole can only gain from becoming globally competitive and from getting imported inputs cheaper It is obvious, of course, that opening up will also mean a better deal for the Indian consumer. Though the industry has become competitive since liberalization it has to improve its productivity levels and quality standards further. The strategy of corporates should address, among other issues, improving the efficiency levels, cost control and cost reduction, efficient working capital management, restructuring both operational and financial, relocation of manufacturing base if required, achieve the economies of scale either through organic growth or exploring mergers and acquisitions in the same line of activity. The prescription is only indicative but not exhaustive. In this context, it is reiterated that successful economic reforms must result in strengthening the ability of governments to do what they need to do by helping to generate higher growth, revenue and productivity. The government initiative to reduce the customs duty to ASEAN levels in the next two years, may be facilitated by reasonable infrastructure particularly roads and ports. The tax incentives on the housing sector, the cascading effect of it would push off take in the cement, steel, white goods sector sales and of course, other sectors up and down the value chain

Service tax is one area which needs to be fully tapped in a bid to improve the tax to GDP ratio; besides, its scope should be widened. Efforts to broaden the base and crack down on evasion particularly of service tax will push up the tax-GDP ratio in the medium and long-term. The tax reform should address the issue of wide range of tax exemptions. The falling tax/GDP ratio also compels a closer look at exemptions.

It is observed that many top corporates did not pay even the Minimum Alternate Tax (MAT). Our tax system is riddled with exemptions, both in personal income tax as well as corporate income. The net result is that the effective rate of taxation is usually well below the nominal tax rate. A more important reason for the falling tax/GDP ratio is that close to 70% of GDP from agriculture and services is outside the direct tax net. Though a beginning has been made in taxing services, much remain to be done in real terms. It is high time that the salaried class, whose income from salary is net of tax deducted at source, should not lose confidence in the taxation system.

The best way to tackle the erosion of the net worth of the GOI is to retire public debt by mobilizing more resources on the receipts side of the budget

The outstanding internal debt of the government is on the higher side. The interest cost alone accounts for the full extent of the fiscal deficit and exceed the revenue deficit, leading to a negative primary deficit. The best way to tackle the erosion of the net worth of the GOI is to retire public debt by mobilizing more resources on the receipts side of the budget.

In short, privatization is the need of the hour. The proceeds from the sale of PSUs hardly may fetch little over Rs. 4000 cr against target of Rs. 12000 cr during the current fiscal year. During the recent past the GOI has successfully brought in strategic investors and privatized PSUs such as Modern Foods, CMC, BALCO, VSNL, Hindustan Zinc, IPCL, Maruti Udyog etc. IOC has taken over IBP at a hefty valuation beating all other bidders by a wider margin, resulting in one PSU being acquired by another PSU. Though, the issue of IOC bidding for IBP created a lot of debate, if it is from the point view of de-risking of the business considering the future industry prospects, it is a plausible proposition based on market-oriented considerations. A stiff opposition has stalled the entire disinvestment process raising objections on the pace and procedures of disinvestment.

The opponents of the disinvestment were against the strategic sales as the preferred mode of diluting the government's stake, strategic importance of the PSU under disinvestment, profit-making and creation of private monopolies. The opposition to the privatization though not expressed by the opponents has also to be viewed in the backdrop of marginalization of the role of ministers concerned in governance that is inevitable once these enterprises are privatized. The opponents sought a review of the disinvestment program. The compromise formula of disinvesting one oil PSU through a strategic sale and the other through initial public offering has found favor with the opponents, of course reluctantly. Dividend stripping needs careful consideration on a case-to-case basis and should not become a norm, no matter how convenient such a norm may be for the exchequer.

Let us now turn to the financial sector. In the case of the banking sector, of the 19 nationalized banks, which account for a overwhelming share of banking business in India, there are Public Sector Banks which would show losses but for interest on recapitalization bonds. The performance of the banks for the previous and the current fiscal should be considered as an exception in view of other income in the form of profit on sale of securities expected to contribute substantially to the bottom line, due

to the historic low level of interest rates. The changes in the foreclosure laws to speed up the repossession of assets, and the removal of archaic legislation that protects defaulting companies are expected to improve the performance of the banks.

Among the most encouraging trends, but one that must be accelerated, is the government's acceptance of some degree of consolidation—for example, the acquisition of some banks by strong local institutions including public, private and foreign.

The Finance Minister in the past has made his intention to retain the 'public character' of banks even after the government's share would be brought down to 33%. The past experience in the banking sector has shown that private ownership is no guarantee of financial health. Though privatization alone is not the panacea, however, it automatically puts a premium on efficiency and performance with a whole new set of incentives and rewards. In short, the government will have to look to private domestic and foreign investors to revive the sector. Such a move could serve them well given the underlying size and growth of the Indian financial services market.

The State elections followed by general elections in mid-2004 may compel the Finance Minister to present a soft budget as populism overtakes pragmatism

As far as forex reserves are concerned there are many problems. The government has made rupee fully convertible on the capital account by allowing individuals, companies and mutual funds to make equity investments in listed foreign companies, of course with some riders. This is a progressive step and in the right direction.

The structural rigidities in the interest rates particularly the small savings rate, needs to be addressed. The low LIBOR rate vis-à-vis domestic interest rates are resulting into arbitraging opportunities. In the present scenario, LIBOR at around 1.7% and GOI paper with one year maturity yields 5% and the investor can borrow at LIBOR plus 50 basis points (approximate) i.e., 2.2%. Despite taking forward cover to hedge against depreciation at an extra cost of 1%, it would result in a net gain of around 2.3% through interest rate arbitraging.

The Finance Minister has to play the role of a facilitator and not just regulator and stay ahead of times. The US President Bush has unveiled an economic plan, calling for the elimination of taxes particularly dividend payment tax across the broad rate cuts, immediate tax relief for the married couples and families with children and bigger incentives for small businesses to invest in new equipment etc.

The combination of record levels of defaults, high-profile bankruptcies, increasing instances of fraud and questionable accounting policies have all resulted in the steady erosion of investor confidence as well as high levels of volatility in the equity markets. A stock market friendly budget that could see abolition of tax on corporate dividends, reducing long-term capital gains tax on equities, a likely cut in the corporate tax rate may boost overall stock market sentiment.

There has never been a problem with the direction of reforms in India, but only with the pace, which is characteristic of any democracy with diverse views on policy issues. The Finance Minister, in his previous budgets promised downsizing of government, Fiscal Responsibility Bill and securitization of the dues of state electricity boards. These issues have to be revisited and implemented.

We should initiate practicing zero-based budgeting system as early as possible. This would do away with a casual approach to government spending. Right now, the belief is that because we have been spending on certain items for several years, that spending should continue. We have to re-examine every item of expenditure periodically to determine whether it is indispensable.

This year's budget is expected to be different. The Finance Minister has refrained from organizing pre-budget consultations with various groups i.e., captains of industry, economists etc. First of all, the very process of preparing budget proposals has been modified to make it transparent. This is technically the last budget of the BJP-led coalition. The State elections followed by general elections in mid-2004 may compel the Finance Minister to present a soft budget as populism overtakes pragmatism.

Sudipa Majumdar

Economist and Proprietor
Newel Consultants

The Finance Minister is expected to chalk out a path for achieving its desired growth goal of GDP of 8%. Although this target has been widely criticized, the Government is expected to remain obstinate about the target.

The Finance Ministry has already indicated to the Planning Commission that it would not be able to provide more than Rs. 1,00,000 cr as gross budgetary support for Plan projects. The Center's actual Plan expenditure has fallen short of budget estimates for six successive years since 1995-96. The Finance Minister has taken a strong stand that increased outlays would depend on

attainment of receipts through taxes, disinvestment receipts, decline in non-Plan expenditure etc. Singh has also drawn up plans for monitoring of Plan projects and suggested that projects that do well at delivery-end could be rewarded with additional outlays.

Now, it remains to be seen how closely Singh follows his measures and intentions because good administration and strict follow-up of such intentions would ensure that the country reduces its fiscal deficit by minimizing wastage of public resources.

What is also important is to assure foreign investors about the continuance of economic reforms in India. The US ambassador to India has made it clear that foreign investors were growing wary over the setback of reforms in India and this was affecting foreign investments. It is, therefore, imperative that the budget brings out policies that would support the reform process and make foreign investments attractive.

The Indian Government has already made some promises to the World Trade Organization, which would be reflected in the forthcoming Budget. Firstly, India has promised that it would smoothen out anomalies in import duty structure for the easy flow of cross-border trade. Secondly, India is supposed to reduce the peak import duty to 20% by 2004-05. So, we expect to see some steps in these directions.

In fact, there are already talks that the government plans to abolish import duty on life-saving drugs, government imports for defense, security and atomic energy and all imports of the Reserve Bank of India.

Even at the micro level, several fiscal distortions have to be sorted out. For example, in the textiles sector, a lower tax regime is required in order to prepare for 2005, the post-quota regime. Similarly, in the automobile sector too, it has been pointed that the current rates of duties are not economically tenable as it makes the total incidence of taxes and other levies more than 65%. So, a lowering of the indirect tax would help to give fillip to the core sectors, and this could, in turn, play a significant role in the economy through its backward and forward linkages.

With more citizens paying their legitimate taxes, the fiscal scenario would improve even by lowering the overall tax burden

What would happen on the overall tax scenario remains to be seen. On one hand, the Indian government needs to raise overall tax revenues, since its public deficit is running at more than 11% of annual economic output.

On the other hand, raising taxes would slow the already stumbling economy. Increase in taxes would also dissuade investors, who are already nervous of operating conditions on the Indian market. Jaswant Singh has commented that the Budget would seek to "put more money into citizen's pockets and housewife's purses," but one also needs to see the macroeconomic implications of this statement.

The corporate taxes should also be looked into, since at present rates, the taxes are impinging into the productivity of the manufacturing sector. Our corporate tax has to be reworked to the extent that it facilitates mergers and acquisitions, favors research, development and entrepreneurship activities.

The Indian Government has proposed sweeping reforms that could slash the corporate tax burden, in line with the Kelkar Committee proposals.

What the government needs to do is to take strict measures against tax evasion, which is rampant in India.

In fact, with more citizens paying their legitimate taxes, the fiscal scenario would improve even by lowering the overall tax burden. It remains to be seen if the new Finance Minister would be able to draw up some interesting steps, in line with international best practice, that would lower the deficit and at the same time lower tax burdens through better enforcement. The Finance Minister has been in favor of a regime of moderate tax rates and further simplification of procedures—India requires moderate tax rates along with higher compliance.

The new Finance Minister's major achievement has been his proposal to introduce complete transparency about taxation proposals of his Budget. According to his plan, all the major taxation proposals would be placed on the Internet in order to allow industry associations, companies and experts to give in their suggestions to the proposals.

The 2003-04 Budget would, in turn, incorporate the suggestions/comments from the Internet on the original proposals. If Jaswant Singh were to make this a reality, it would surely be a major breakthrough in bringing about transparency in the taxation system and go a long way leading India on to a desired growth trajectory.

Reference # 1-2003-02-08

The views expressed are the personal views of the participants and not necessarily of the organizations they represent.

HYUNDAI MOTOR AMERICA

The turnaround

Crippled by an image of bad quality, Hyundai Motor America was struggling with sales slump until Finbarr O'Neill improved the quality and lured the customers through warranty scheme.

Four years ago, Hyundai Motor America, the subsidiary of Korean auto giant Hyundai Motors, was in the worst of states. It had a shoddy image that slumped sales, its brands competed more with used cars rather than new ones in the US; its customers were mocked by the marketing elite as 'captive resentfuls', who could not afford better brands. What's more, its poor models sagged sales to a measly at 90,000 cars a year, just enough to sustain its infrastructure. Worse still, the company was without a CEO for months.

Before considering a possible shutdown of its American subsidiary, the South Korean conglomerate, in its last effort appointed Finbarr O'Neill as the Chairman and CEO in 1998 entrusting him the mandate to turnaround the poor state of affairs.

Growth at the cost of image

By 1986, most automobile makers moved on to the high-end, high-priced vehicles, leaving a huge vacuum in the entry-level market. As a result, first-time purchasers mostly consisting of college students and nesting families (young couples) were faced with non-availability of economically priced cars that catered to their needs. Sensing this gap and clocking perfect timing, Hyundai entered the US market in February 1986, by launching subcompact Excel model. Predictably, this launch met with huge success selling a record number of around 1,00,000 Excel models within seven months of the launch. The total sales for the year 1986 were 168,882, which was an industry record for an import car distributor in its first year. The success streak continued into the next year—in 1987, when sales reached a record 263,610 units.

Hyundai's blockbuster sales are more noteworthy because it managed with dealers in only 31 of the 50 states. Initially, Hyundai focused its sales efforts on the east, west and in the southern states, but later, in 1987, expanded the operations into the central United States. Today, there are four regions and nearly 600 Hyundai dealerships nationwide. In 1989, Hyundai decided to become a full-line automotive importer/ distributor and introduced its mid-size Sedan—the Sonata, which broadened the company's appeal and thereby expanding its market to more mature and bigger families. The Sedan offered the Excel owners an opportunity to upgrade within Hyundai product portfolio, so that the company doesn't lose the market to its competitors.

In its eagerness to offer a full-product line to capture all the segments of the market, the company did little to address the bad perceptions which the customers had regarding its image. It was still perceived as a cheap car for the economy segment. Hyundai brands had acquired a negative reputation for their unreliable quality, durability, and imperfect fit, dowdy, down market styling and cheap prices. In fact, Hyundai brands were referred to as 'econoboxes' from the Koreas. All this curtailed the growth in sales of Hyundai's products, while the company continued to chase its full-product line or up market dreams. "Hyundai Motor America probably had the strongest and most talented distributor organization and dealer body of any new franchise ever launched in the USA. The products were the reason for the near failure of the venture. Early customers were stranded with poor products with poor support and quickly the word spread that Hyundais were a poor selection," says George Peterson, President, AutoPacific, Inc. He adds that Hyundai's early problems in the USA were due to the poor quality of the Hyundai Excel sold in the USA in the late

1950s and early 1980s. Hyundai did not have adequate parts and service capabilities to handle these quality problems, and lacked new products to broaden the product line quickly. Then again, the most important impediment to the progress of Hyundai was its hubristic attitude. Peterson airs similar views, 'the fact that Hyundai's launch was so strong ... Selling about 260,000 units by the second year ... gave the Korean management a confidence they did not yet deserve".

Introspecting times

The launch of many mid market and up market models continued despite sales decline all through the 1990s. By 1998, Hyundai was faltering and the parent company wasn't able to get an able CEO to stem the decline. O'Neill was Hyundai's corporate lawyer since the company's US entry. He was the acting COO in 1998 when the company was still in the search for a CEO. To control falling sales in the short-term and to stop further deterioration, he was made the CEO by the parent company the same year, while searching for a candidate to fill the position for the long-term who can lead the company out of its struggles. While critics claim that lawyers don't run companies, O'Neill embarked upon the task of restoring financial health to Hyundai's American unit. By using rationale thinking, keen sense of detail and the much needed fortitude, he started identifying problems and solving them one at a time.

He ascertained that poor quality was the major problem that was driving down sales and worked towards boosting quality. But, despite efforts to improve quality and styling, customers weren't turning up to buy Hyundais. The sloppy image of the brand was so entrenched in their minds that they refused to buy any arguments in its favor. Here, the lawyer in O'Neill took over; he sat with his dealers for hours, jotting down their suggestions, listening to their problems and all the while searching for those hidden answers to get customers to buy their brands.

Warranting its image

O'Neill first undertook a study to identify the causes of customer apathy. After a detailed observation of the report of the study, he found that customers were worried about the quality and styling aspects and therefore he decided on a mandate of 'taking the fear' out of the customers' mind. Even though, Hyundai had been paying serious attention to quality aspects right from the late 1990s, customers' apprehension hadn't changed—they knew little or rather they believed little of what Hyundai had done on the quality front. Indeed, as Hyundai's brands got better, its repute got poorer. O'Neill reasoned that the consumers had to experience its brand in order to trust its improvements and that they wouldn't believe if the company just said so. What better way to entice customers toward a product than a warranty? Hyundai, hence, started offering a 10-year, 100,000-mile warranty on its cars. To top it, it added a $750 cash rebate. At a time when most of its competitors like General Motors, Ford and Chrysler offered small incentives to buyers, Hyundai's warranty was extraordinary and was the right kind of bait at the right time.

O'Neill, an astute lawyer, knew very well that if Hyundai had to spend millions of dollars on fixing broken vehicles, it would be out of business even before it could mend itself. So, he came up with the ultimate incentive known as 'America's best warranty' which included six years of bumper-to-bumper coverage and 10 years of coverage on the car's engine and transmission. The catch was that because of the warranty commitments the company would be more careful in quality and styling so as to minimize warranty service costs. This 'warranty' scheme has complemented the broadened product line of Hyundai, which was actually needed since long.

What Affected the Turnaround
Views of George Peterson, Autopacific Inc.

- The revaluation of the won to the dollar in 1997 gave HMA much more latitude to support its products. Even at the same price, HMA immediately was making more money on each car sold. It could then put this additional revenue into marketing programs, incentives, warranty etc.
- Hyundai Motor Company was disconnected from Hyundai Heavy in 1997. All of a sudden, without excess profits being siphoned off to the parent company, Hyundai Motor found itself profitable. HMC money had been previously used to support unprofitable ventures like ship-building, semiconductors etc. This additional money was invested in acquiring 49% of Kia and in developing new products.
- The extraordinary Hyundai warranty is the number one reason owners give for buying their new Hyundai vehicle. The warranty has given Hyundai immediate credibility than before.
- Products at a good value.
- Good products. The Hyundai Santa Fe sport utility vehicle has won AutoPacific's Vehicle Satisfaction Award for its class for two years in a row. In 2002, the Hyundai Sonata Sedan won in its class. This is the first time a Korean brand has won any award we have given.
- Improving products. Quality has become a mantra at Hyundai Motor Company and HMA. This has to be solidly institutionalized for Hyundai to challenge the Japanese as they have stated they want to.

Besides curbing customer fears by means of promising warranty, O'Neill made every possible effort to transition its brand from being just functional to becoming fashionable, so as to suit the needs of style-conscious American consumer. So, even though Hyundai enjoyed plump margins in the US, it didn't go for price cuts to gain market share. Instead, it pumped the surplus cash back into its vehicle offering customers trendier designs, add-ons like leather seats, and side air bags. It was also careful to adhere to the safety norms. To give buyers sleek, trendy cars, O'Neill invested in design centers in Michigan, Germany and Japan. Hyundai recently started a $1 bn Alabama factory and a new $25 mn California studio is about to start to craft designs customized to suit the American taste. Those moves, believes O'Neill, will let Hyundai sell one million cars by 2010, almost three times its sales of 375,000 cars in 2002. And, like other major automakers, Hyundai began to integrate its suppliers into the manufacturing process, to drive down costs. With Neill being able to sort out and fix the 'quality' related problems, the first phase of the turnaround was, indeed a success.

With Neill being able to sort out and fix the 'quality' related problems, the first phase of the turnaround was, indeed a success

Planning ahead

While the 10-year warranty plan brought in sales, the executives hired by O'Neill from rivals such as Nissan and Honda brought in professionalism. At the same time, the styling bestowed improved car ratings, which translated into new customers and favorable exchange rates between South Korea, and the United States allowed Hyundai to offer more features at lower prices than many competitors. A mix of all these affected the turnaround. Today, Hyundai continues to reinforce its commitment to sell innovative, high-quality vehicles at the most affordable prices. Its sales are 400% ahead since 1998, when O'Neill took over and now outpace Volkswagen and BMW.

Hyundai's new compact SUV, the Santa Fe, had nabbed customer satisfaction and safety awards and has become something of a cult favorite. Hyundai's sleek, sporty, six-speed Tiburon is also getting positive reviews. Customer loyalty has more than doubled since 1998 from 17% to 36%. Moreover, in the first four months of 2002, it had sold 36,000 vehicles more than General Motors Corp.'s Saturn, which was promoted as an 'import killer' to ward off competition from Japanese and Korean automobile companies. The company has achieved record sales for each of the past 18 months, and sales in the US have quadrupled during the past four years, giving the company an American market share that is equal to that of Volkswagen. (This year, Hyundai expects to sell about 370,000 cars. O'Neill's goal is to sell 500,000 units a year by 2005.)

Zipping the future

As Greame Maxton, Economist and Co-founder of *autoPOLIS* Magazine, says, "Hyundai has a much better model line-up and a stronger market position than before. Some of its competitors—notably the big three—are also likely to weaken, giving additional scope for share growth". Even Detroit's biggies like Chrysler, Mazda and others have followed Hyundai's lead and extended their warranties. GM executives are grumbling that Hyundai is succeeding because of the weak Korean won. But critics point out that Detroit had a similar gripe when the Japanese came on strong.

In the same breath critics question the automaker's decision to manufacture in America rather than import cars from Korea. (The company has invested in a new assembly plant that will start manufacturing its popular brands—Sonata and Santa Fe—by 2005). They ask how the company would retain the price advantage as it presently enjoys by importing cars from South Korea. There's no doubt that a key element of Hyundai's sales success is its low prices. The company's cars are typically several thousand dollars less than comparable Japanese products. Maxton agrees, "the collapse in value of the won following South Korea's economic crisis (the Won fell by 50% in a year) allowed the company to price its cars much more aggressively, increasing car sales by 150% between 1998 and 1999 alone. Until then, the company had been on the fringes of the US market with flat volumes."

Hyundai says it will offset those higher costs with the most automated facility in North America. It will also rely heavily on modules from suppliers to keep the number of labor-hours needed to assemble a vehicle at very low levels. And it will be an integrated manufacturing facility, including a stamping and an engine plant. The company also points out that it will help it cut other non-manufacturing costs and become more responsive to what the market wants. The overhaul is complete—with the manufacturing facility in place and Hyundai Motor America has reinvented itself as an American company, just like most of its Japanese rivals did. It remains to be seen whether Hyundai would be able to replicate the success of its Japanese rivals in doing so. With all the success going to his credit, O'Neill has cemented his position as the future CEO simultaneously brightening the prospects for Hyundai in America.

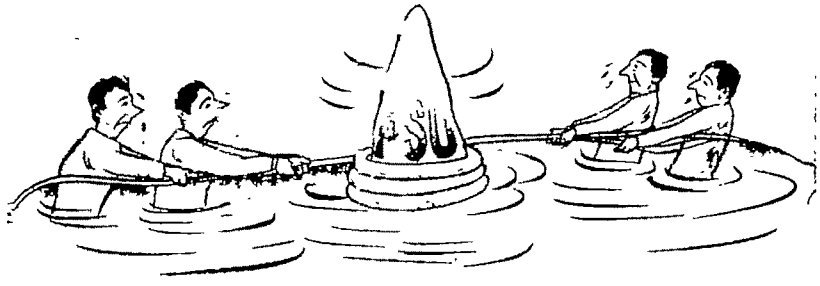
C S V Ratna

Reference # 1-2003-02-09

PSU DISINVESTMENT

Controversies and compromises

Apart from unlocking their productive potentials, disinvestments also galvanize PSUs to promote high quality employment and competition in the marketplace, says Dr. A S Harish, Senior Manager, The Vysya Bank Limited.



The Government of India (GOI) started disinvestment way back in 1991-92, under the new policy of liberalization. Public Sector Units (PSUs) shares were initially issued to local financial institutions and banks, a major chunk of it being placed with Unit Trust of India. The actual realization from disinvestment from 1991-92 to date is around Rs. 20,888 cr. The bundling and bidding were adopted as the first method of disinvestment, subsequently followed by the tendering and issuance of the Global Depository Receipts (GDR). The auction and public float methods were never used for effecting disinvestments. The Department of Public Enterprises (DPE) was the nodal agency to steer the disinvestment process. The DPE was empowered to prepare the bundles, advertise the bids, select the bidders, finalize the price and effect disinvestments. The government focused only on disinvestment of shareholding without taking into consideration other important issues such as the initial public offer, involvement of strategic partners, offloading shares in the capital market, book-building process, etc. It also did not touch upon issues such as transfers, mergers, acquisitions and issues relating to restructuring of PSUs. However, during the recent past the GOI has successfully brought in strategic investors and privatized PSUs such as Modern Foods, CMC, BALCO, VSNL, Hindustan Zinc, IPCL, Maruti Udyog etc. IOC has taken over IBP at a hefty valuation beating all other bidders at a wider margin, resulting in one PSU being acquired by another PSU. For instance, IOC has taken 33.58% in IBP at a price of Rs. 1,551 per share and paid Rs. 1,153.68 cr to government at a price-earnings ratio as high as 63. Though IOC has justified the valuation, it surprised the majority of the players in the stock market. The moment GOI started moving on a faster pace for disinvestment of oil PSUs in general and HPCL, BPCL in particular, well-known brand in India, a stiff opposition stalled the entire disinvestment process raising objections on the pace and procedures of disinvestment. The opponents of the disinvestment were against the strategic sales as the preferred mode of diluting the government's stake. Under strategic sale, the government transferred part of its holding to a strategic partner who will control the operating and financial policy of the enterprise. The strategic partner is identified through an elaborate bidding process. The transfer of ownership is subject to certain restrictions through covenants. The other reasons advocated against privatization of PSUs include, strategic importance of the PSU under disinvestment, profit making and creation of private monopolies. The opposition to the privatization though not expressed by the opponents has to be viewed in the backdrop of marginalization of the role of ministers concerned in governance that is inevitable once these enterprises are privatized. It is also expressed by the minister that Bharat Sanchar Nigam Limited (BSNL) and Mahanagar Telephone Nigam Limited would not be privatized in the near future. The stalling of the disinvestment process also has led to the reopening of the previously settled privatization of a few companies. The opponents sought a review of the disinvestment program. The compromise formula of disinvesting

one oil PSU through a strategic sale and the other through Initial Public Offering (IPO) has found favor with the opponents, of course reluctantly.

Controversies

The debate, controversies and compromises on disinvestment are currently making headlines. The anti-disinvestment faction particularly within the ruling coalition has become vocal and aggressive. Of late, it was the disinvestment euphoria that has improved the overall market sentiment, resulting in the total PSU market capitalization moving up significantly. The Bombay Stock Exchange Public Sector Unit (PSU) index which is the benchmark for PSU performance on the stock market has moved up substantially during the last year.

The BSE PSU Index which tracks the performance of some of the listed PSU stocks on the Bombay Stock Exchange including banking stocks has exhibited an upward trend as evident from 52- Week High and Low of BSE PSU Index and the index as on December 13, 2002 vis-à-vis 52-Week High and Low.

More than 60% of the BSE PSU market capitalization is accounted for by companies under the broad industry group of oil and gas followed by the banking industry with an exposure of around 18%. The euphoria was more pronounced in prices of oil stocks such as IBP, HPCL, BPCL and other stocks such as NALCO, Engineers India, Shipping Corporation of India etc. The banking stocks too participated in the rally, despite the government to move aggressively in this sector except permitting 49% FDI in private banks. The trigger to banking stocks was provided by softening of interest rates, promulgation of the securities ordinance facilitating banks to recover delinquent assets and the expected consolidation in the industry. The imbroglio over the disinvestment of HPCL and BPCL move resulted in PSU stock prices crashing in particular and overall market in general. The postponement of disinvestment decision had also resulted in downgrading of Indian paper by S&P.

Let us now turn to the issues raised against disinvestment. The issues raised against disinvestment as already pointed out are mode of investment i.e., strategic vis-à-vis public offer, profit making, creation of private monopolies and strategic importance of the PSU under disinvestment.

It is to be appreciated that wealth of PSUs belong to the entire population of the country not to chosen few who participate in the stock markets

One of the yardsticks for measuring the huge productive potential of the public sector enterprises is the disinvestments receipt from such enterprises, relative to the losses they presently incur, or the net present value of the low profits.

It is evident that the government has approximately received Rs.11,315 cr. The opportunity cost at 10% works out to around Rs. 1,140 cr. However, PPL and JESSOP led to an average annual outgo of Rs. 126 cr. Thus on an aggregate basis, government lost Rs. 73.59 cr. Strategic sale of part of the equity has resulted in benefit to the tune of Rs. 1140 cr + 74 cr = 1213 cr. It is stated by the disinvestment ministry that there can be no justification for maintaining public sector character in these industries/ companies, if the taxpayer has to lose more than Rs. 1,213 cr every year by non-privatization.

As per the traditional parameter i.e., price/earnings ratios for valuation of security too would give a level of comfort for sale of equity through strategic route.

The rough estimate is that the government is going to fetch substantially higher amount by sale of oil PSUs through strategic sale route as compared to public offer mode. The strategic route for divestment followed in recent years has yielded good dividends. This has resulted in market capitalization of PSUs going up clearly demonstrating the confidence shown by the investing community in this mode of divestment. The disinvestment through the public offer mode, is justified on the grounds of sharing the wealth with people. It is to be appreciated that wealth of PSUs belong to the entire population of the country not to chosen few who participate in the stock markets. The implicit assumption is that public will buy shares at the prevailing market price. But the moment it is known that the government will not relinquish control, the price will crash. Therefore, the proceeds from whatever limited sale takes place will be meager. But quite apart from unlocking their productive potentials, disinvestments does also galvanize these enterprises to promote high quality employment as well as competition in the marketplace.

In the Indian context, we have to examine whether the government would really let go off control after a public offer and appetite for stocks of government companies. There is also the question of whether our markets have the depth to absorb the offerings of such companies. Going by the current trends, there should be appetite for stocks such as BPCL and HPCL but the government may have to price them attractively in relation to the market price. This would mean that its realizations would suffer but then, the positive offshoot could be that such an offer will lend much needed vibrancy to the domestic markets. The government would

Disinvestment – Target, Receipt and Mode

Year	No. of cos. in which equity sold	Target Receipt for the year	Actual Receipts	Methodology
1991-92	47	2500	3038	Minority shares sold by auction method in bundles of 'very good', 'good', and 'average' companies.
1992-93	35	2500	1913	Bundling of shares abandoned Shares sold separately for each company by auction method.
1993-94		3500	Nil	Equity of seven companies sold by open auction but proceeds received in 1994-95
1994-95'	13	4000	4843	Sale through auction method, in which NRIs and other persons legally permitted to buy, hold or sell equity, allowed to participate
1995-96	5	7000	362	Equities of four companies auctioned and government piggy backed in the IDBI fixed price offering for the fifth company.
1996-97	1	5000	380	GDR (VSNL) in international market.
1997-98	1	4800	902	GDR (MTNL) in international market.
1998-99	5	5000	5371	GDR (VSNL) / Domestic offerings with the participation of FIIs (CONCOR, GAIL). Cross purchase by three oil sector companies i.e , GAIL, ONGC and Indian Oil Corporation.
1999-2000	2	10000	1829	GDR—GAIL VSNL-domestic issue, BALCO restructuring, MFIL's strategic sale and others
2000-01	4	10000	1870	Strategic sale of BALCO, IJMC, KRL (CRL), CPCL (MRL).
2001-02	10	12,000	5632#	Strategic sale of CMC – 51%, HTL – 74%, VSNL – 25%, IBP – 33 58%, PPL – 74%, and other modes· ITDC, HCI, STC MMTC
2002-03	6	12,000	4748#	Strategic sale of JESSOP – 72%, HZL – 26%, MFIL – 26%, IPCL – 25% and other modes HCI, ITDC and Maruti
Total	48 *	78000	30888#	

* Total number of companies in which disinvestment has taken place so far.

\# Figures (inclusive of amount expected to be realized, control premium, dividend/dividend tax and transfer of surplus cash reserves prior to disinvestment etc.)

have to take a call on how much it can sacrifice to keep the privatization program going. The book-building route, which offers the twin advantage of transparency and efficiency in pricing, can be adopted Now it has been decided that there will be an open offer for Bharat Petroleum Corporation, and a strategic sale of Hindustan Petroleum Corporation. Besides in cases of both BPCL and HPCL, a specific percentage of shares to the employees of the two companies at one-third of the market price will be allotted. The Finance Ministry has also been asked to prepare a paper on the feasibility of setting up an asset management company to monitor and manage the residual holdings of the government in disinvested PSUs. However, there is not much of a disagreement on the usage of the money for social purposes and building infrastructure, which would benefit majority of the population.

There is often an argument that the Government should not sell profit-making companies. BALCO was a profit-making company, which earned the government an average dividend (over eight years) of Rs. 5.69 cr every year on the equity sold. As against this the government would now get Rs. 82.65 cr every year. CMC was a very well managed and profitable company, yet the average dividend was only Rs. 0.80 cr. The government's benefit now is Rs.15.2 cr annually. Similarly, Maruti Udyog Limited gave average returns to the tune of Rs. 13 cr annually to the government and IPCL gave Rs. 16.24 cr on equity sold against Rs. 242 cr and Rs. 149 cr respectively. The similar arguments hold true for other companies disinvested. In the liberalized environment it is but natural for even the profitable companies to lose market share and the margin. It has already been proved in the case of Maruti and now VSNL controlled by Tatas. In the Oil sector, for example, private competition is already free to enter the high margin retail business. Reliance's network may sooner or later eat into the market share and margin of both HPCL and BPCL. It is good to exit when the industry prospects are bright. In the emerging highly competitive environment, when the prospects of generating good returns diminish, they may not even look at PSUs or they may be valued at ridiculously low levels. Again, this is to be viewed in the context of time value

BSE Public Sector Undertaking (PSU) Index Base Date. February 1, 1999 Base Value. 1000 December 13, 2002 1571 92			
All Time High	All Time Low	52-Week High	52-Week Low
1700 95 April 2, 2002	717.69 October 24, 2000	1704.79 June 17, 2002	872 03 December 28, 2001
Source Bombay Stock Exchange, Mumbai			

of money. Now that our import restrictions and tariffs have come down considerably, monopoly power in the domestic market is difficult to sustain.

Regarding the issue of strategic importance of the PSUs, it would be desirable to build certain preconditions in the agreements itself as to the expected behavior of the new management in times of war etc., rather than stalling the divestment program. In sectors that are deemed to be strategic, there would be a case for retaining one player in the public sector. But other than that, private sector firms and market forces must be allowed to compete on a level playing field. There are more market-savvy ways of ensuring that the strategic partner acts in the best interests of the divested company. For instance, the government has succeeded in the case of Maruti Udyog Limited. The Suzuki company, the acquirer of Maruti, paid Rs. 1,000 cr to GOI for controlling interest. It further committed itself to underwrite two IPOs in future, through which the GOI would disinvest its shares. Translated to either BPCL or HPCL, it could be that GOI now offloads a part of its stake to a strategic partner who also underwrites a future IPO of the remaining or part thereof. Once, the base underwriting price gets fixed in advance as in the case of Maruti, it is in the best interests of the strategic partner to ensure that the company is run efficiently and effectively. Any asset stripping would certainly impact on the public offer and may endanger devolvement. On the other hand, if the markets improve, say after two years, the GOI could get a handsome premium on the IPO, which would be priced as per the then prevailing market price or the base price already fixed, whichever is higher. This would satisfy the opponents of the disinvestment through strategic sale route which have been hankering for sale through IPOs.

Time to fine-tune

The government has sold Modern Foods to Hindustan Lever Limited, BALCO and Hindustan Zinc to Sterlite Group, CMC and VSNL to Tata Group and IPCL to Reliance Group. Disinvestment issues, which have created controversies, now however need a mention at this juncture. This includes the resale of the Centaur Hotel by its new owner and Batra Hospitality Services, to the Sahara Group. The successful

BSE PSU Index Comprises

Rs. in cr.

Company	Industry	Mkt Cap as at December 13, 2002		% to Total
Rashtriya Chemicals	Agriculture	1004.07	1004.07	0 66
BHEL	Capital Goods	4091 16		0.00
Bharat Electronics	Capital Goods	1418 80		0 00
BEML	Capital Goods	286 94		0 00
Dredging Corporation	Capital Goods	714.00	6510 90	4 29
HOCL	Chemical	123 95	123 95	0 08
HMT	Diversified	983.16	983 16	0 65
State Bank of India	Finance	14554 8		0.00
Corporation Bank	Finance	1772.92		0 00
Bank of Baroda	Finance	2046.84		0.00
Bank of India	Finance	1834.62		0.00
Punjab National Bank	Finance	1655 49		0.00
IDBI	Finance	1263 23		0 00
Oriental Bank	Finance	947.30		0.00
Union Bank	Finance	842.02		0 00
Andhra Bank	Finance	810.00		0 00
Indian Overseas Bank	Finance	642.74		0 0
Dena Bank	Finance	261 63	26631.59	17 56
Steel Authority	Metal and Mining	3696.71		0.00
National Aluminum	Metal and Mining	6124.16		0.00
Neyveli Lignite	Metal and Mining	4222.44	14043.31	9.26
Engineers India	Miscellaneous	1669.64	1669 64	1 10
ONGC	Oil and Gas	51084 09		0 00
ICO	Oil and Gas	17724.38		0 00
HPCL	Oil and Gas	9334 97		0 00
BPCL	Oil and Gas	6578 47		0 00
Gas Authority (GAIL)	Oil and Gas	5864.59		0.00
Kochi Refineries	Oil and Gas	623 16		0 00
IBP Limited	Oil and Gas	535.96		0 00
Chennai Petroleum	Oil and Gas	409.67	92155 29	60 78
Mahanagar Tele (MTNL)	Telecom	6533 10		0 00
ITI Limited	Telecom	200 20	6733.3	4 44
Container Corporation	Transport	1769.72	1769 72	1 17
		151624 93	151624.93	100 00

Source Bombay Stock Exchange, Mumbai

Strategic Disinvestment Beginning 1999-2000 – A Few Cases

Rs. in cr

Sr.	Name Sold	GoI Equity Realization		Govt. borrows @ 10% Interest on	Dividend recd. by govt. on equity sold Average of last eight years up to 2000
1.	Modern Foods				
	I Phase	9.63	105	10.50	0.48
	II Phase	3.38	44	4.40	0.17
2.	BALCO	112.52	326.50	82.65	5.69
3.	CMC	7.73	152	15.20	0.80
4.	HTL	11.10	55	5.50	0.29
5.	IBP	7.44	153.68	115.36	1.84
6.	VSNL	71.25	3689^	368.90	10.40
7.	Hindustan Zinc Ltd.	109.85	445	44.50	3.50
8.	Maruti Udyog	66.00	2424^^ **	242.40	13.00
9.	IPCL	64.50	490.84	149.00	16.24
10.	Others (ITDC Hotels, PPL, JESSOP etc.)	427.63	929.81	101.46	(126)
	Grand Total	891.03	11314.33	1139.87	73.59

^ Including Dividend and Dividend tax.

** Expected

^^ Minimum amount to be received over three tranches; could go up to Rs. 3158 cr.

bidder in this case could reap a windfall of around Rs. 32 cr (bought the property at Rs. 83 cr and sold for Rs. 115 cr), in less than four months. Logically speaking, a major part of such gain ought to have accrued to exchequer, if the bidding process had been more effective. The disinvestment minister maintained that there was nothing in the shareholders agreement, which is an essential covenant, that could have stopped the transaction. The government ought to clarify as to whether the Sahara Group was trying to sidestep any covenants that the disinvestment policy might have prescribed. Another controversy which needs a mention, of course, is the privatized VSNL's decision to invest substantial sums in a Tata group company though is abating now, but was an issue recently. The Reliance's takeover of IPCL ought to have spurred the introduction of competition law. The above issues only expose the lacuna in the policy, but can be corrected proactively as the process moves on. There is nothing wrong in fine-tuning and effecting a mid-course correction.

It is seen over a period of time that the divestment of government stakes in PSUs continue to be plagued with missed opportunities. In the case of CMC, for instance, at the end of the long process, there was finally one bidder for acquiring the government stake. Had the CMC been sold a couple of years ago, when the information technology sector was at its peak, the price realized would have been much more. The story is similar as regards to the proposed sale of government stake in Maruti Udyog Limited. The price that has been realized from the sale was much less compared to the price that Suzuki would have paid on the earlier occasion. In the case of VSNL too, the government sold its stake at less than half the price it would have got several years ago.

Future plans

The disinvestment proceeds are pegged at Rs. 78,000 cr in the Tenth Plan Period. On an annual basis, a target of Rs. 78,000 cr means that the government has set itself a target of Rs. 15,600 cr to be realized from disinvestment this year. The current year's disinvestment target in Budget 2002-03 was Rs. 12,000 cr. The government has so far realized less than Rs. 5,000 cr this fiscal from disinvestment indicating a slower than estimated pick-up in the momentum of such receipts. The target of Rs. 12,000 cr can just about be realized if disinvestments in National Fertilizers, Shipping Corporation of India, State Trading Corporation, National Aluminium Company, Engineers India Limited and Maruti are completed. An oil company privatization of either HPCL or BPCL would have enabled the government to cross the disinvestment target. It is reported and again denied in press that the government may ask profitable PSUs like ONGC, EIL etc., for special dividend. There is nothing wrong on the government's part to demand special dividend from companies, which are up for disinvestment, the logic being to maximize realization. The dividend pay-outs however should be high for companies with no expansion plans, in which case idle cash becomes a liability as it depresses returns. If we were able to apply this logic to our PSUs, ONGC would probably be the first to be exempted from declaring dividends. The draining of ONGC's cash is not in the long-term interest of the company, though it might be the easiest way to make good the shortfall, if any, in disinvestment.

Give impetus to reforms

Many public sector enterprises in India may be inefficient and loss-making, but that does not automatically establish the superiority of the private sector. The recent revelations of corporate and accounting scandals have shaken the very foundations of the American capitalist model, which the present day policy makers appear keen to replicate in India. The PSUs bidding for each other should be discouraged as it results in maintaining *status*

quo unless it gives a leeway to a particular PSU to compete with other private players in the same industry. It is becoming increasingly clear that the principal business of governments all over the world is to govern and facilitate economic growth not to run businesses on their own. There is no reason why India should be an exception to this inexorable progression.

The postponement of disinvestment may not bring the overall reforms process to a halt; it will certainly weaken the impetus to perform across the broader reforms agenda. The disinvestment ministry will do well to enlist the support of the Finance Ministry, as they have a converging interest in improving the fiscal conditions of the government. It is highly desirable that the disinvestment should not be looked at from revenue perspective but to unlock the productive potential inherent in the PSUs cumulatively improving the competitiveness of the economy. Hence, the focus should be on filling the public relations vacuum and creating a facilitating environment, which is conducive to divestment.

Given the pace at which India's disinvestment program has moved so far and the plethora of issues that have been raised in the public domain in relation to Public Sector Units such as HPCL, BPCL, NALCO etc., perhaps there is merit in revisiting the approach in executing the disinvestment process. The roadblocks to oil PSUs can also be attributed to the too much of an attachment by the ministers concerned. For instance, in the case of HPCL and BPCL, the companies' gas stations, refineries, guest houses, company vehicles etc., would be passed on to the strategic investors and the same logic holds true for other PSUs as well. In view of the above, it is desirable to switch portfolios and enhance the value of the oil companies chosen for divestment by unlocking its value and getting a better value in future divestment by capitalizing on the future potential of the companies.

The postponement of disinvestment may not bring the overall reforms process to a halt; it will certainly weaken the impetus to perform across the broader reforms agenda

Though the government has given the green signal to proceed with the disinvestments process, it is too early to raise a cheer, as significant elements in the government still remain opposed to privatization. It is proposed now, that the government will disinvest to retail investors, in the case of BPCL which therefore will continue to be majority-owned by the government, and HPCL will be put on the block for strategic sale. However, ONGC and Gail may be allowed to bid for it. This raises the possibility that ONGC will own HPCL after Indian Oil has already bought IBP, while BPCL remains a PSU, so that at the end of the entire exercise we are back to square one. Besides, no time-frame has been fixed for divestment. The future course would also depend on the outcome of the Gujarat Elections. The electoral politics will now have a larger say on the government's reforms agenda. Besides, Gujarat with elections to 10 state assemblies due next year, followed by General Elections in 2004, the political compulsions must move ahead of reforms, particularly divestment.

There has never been a problem with the direction of reforms, but only with the pace and effective execution, which is the characteristic of any democracy with diverse views on policy issues. Primarily the various issues raised by the opponents have to be discussed thoroughly and apprehensions have to be addressed objectively. Subsequently, the issues have to be resolved through a transparent comprehensive divestment policy, which should ultimately result in non-frictional divestment process.

Price to Earnings Ratios
Sale of Shares vs. Strategic Disinvestment

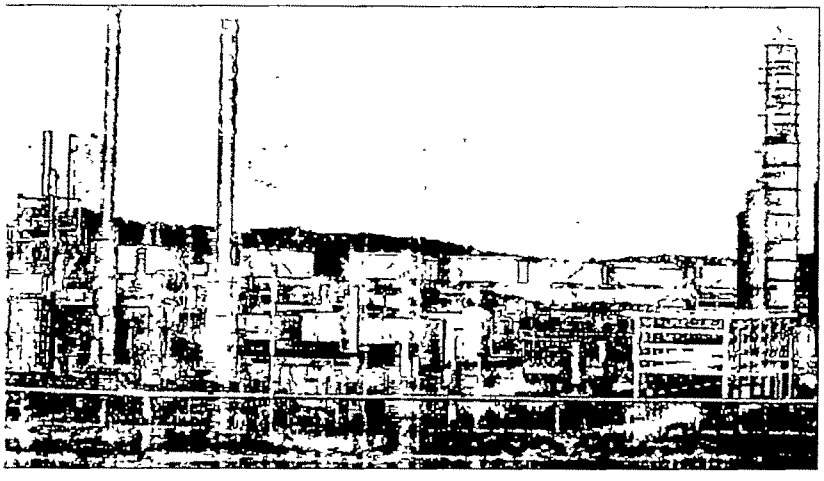
	Sale of Shares 1991-99		Strategic Disinvestment 2000-2002	
1	IOC	4.9	BALCO	19
2	BPCL	5 7	CMC	12
3	HPCL	5 9	HTL	37
4	GAIL	4 4	MFIL	Very high as earning per share was negative.
5	VSNL	6.0 (in monopoly days)	LJMC	-do-
6			PPL	-do-
7			JESSOP	-do-
8			IBP	63
9			VSNL	11 (inclusive of income from dividend etc.) (After the end of monopoly)
10			HZL	26
11			MARUTI	89
12			IPCL	58

Reference # 1-2003-02-10

THE INDIAN OIL AND GAS INDUSTRY

Leaping forward

The discovery of new gas reserves in the eastern coast of India has changed the face of the Indian oil and gas industry altogether. With the assurance to reduce the widening demand-supply gap, the new discoveries may take India on its path to energy security.



Ever since Reliance Industries Limited (RIL) announced its discovery of the gas reserves in the Krishna-Godavari basin of Andhra Pradesh, the activity in the Indian oil and gas industry has sprung back to life. The discovery has marked the dawn of a new era in the history of India. According to the chairman of RIL, the discovery is one of the biggest in the last three decades in India and one of the biggest in the world too in the year 2002. No doubt, this new discovery will boost the creation of a new energy security for India. Madhu Nanian, Editor, *Petrowatch India*, says, "The discovery of gas in the KG deepwater block by Reliance is a very significant event from the point of view of India's energy hunger. Suddenly, it seems, there is a lot of gas going around in India."

Renewed confidence

With the discovery of the gas reserves by RIL with a capacity of 40 million cubic meters per day, the industry is confident of further such discoveries in the region. In fact, ONGC reported the discovery of gas in the KG basin immediately after the announcement of RIL. This indicates the possibility of a gas base at the eastern coastal region of the country. Ironically, after the Bombay High, KG basin has been the most successful region so far. Out of the 19 billion cubic meters per day, 8 million cubic meters are produced every day from the onshore and offshore fields in Andhra Pradesh.

The new discovery has come at the right moment for the energy hungry India. Identifying the need for development of gas fields in India, the government has divided the prospective regions into different blocks and invited bids from private players under the scheme 'New Exploration and Licensing Policy (NELP). The RIL discovery is the first of its kind. Megha Shukla, Area Coordinator, Tata Energy Research Institute, comments, "The discovery of natural gas reserves by Reliance has been the first discovery under NELP and is also the largest after South Basin discovery years back." She further adds, "The new discovery by players like Reliance and GSPC have clearly proved that India has adequate domestic resources, what we need is adequate utilization. This also gives a positive indication that India is likely to discover more such reserves under NELP in the years to come."

In fact, doubts have been expressed about the success of NELP at different times. With the discovery of gas reserves by RIL, ONGC and GSPC the confidence in NELP has improved. The timing of the discoveries was so perfect for the government which is contemplating the fourth round of NELP bidding in the coming months. The discovery of gas reserves in different blocks will no doubt induce the players to participate in the future rounds of bidding. This will propel the domestic gas exploration initiatives of the government in a big way. With increasing emphasis on hydrocarbon in the present conditions, the dream of achieving self-sufficiency appears realistic. Opines Megha, "At present, natural gas holds about 8% in the India's total primary energy consumption and as per the projections made by the Hydrocarbon Vision 2025 Report, this share is expected to rise to about 20% by 2025. This now appears realistic with such discoveries taking place under NELP."

Before the discovery of oil, the success of NELP has been debated much. According to Megha, "NELP has offered several incentives to oil and gas companies from India and abroad, both from public and private on a level-playing field. The bidding pattern clearly points out that NELP has attracted private players and the new discoveries are

giving it the impetus." Echoing a similar viewpoint, Madhu, opines, "They do indicate the success of NELP. Because these blocks were carved out by DGH after 2D seismic surveys. DGH Chief Dr. Avinash Chandra says, he has been telling everybody from 1996 that India's eastern offshore could surpass the western offshore in hydrocarbons. According to him, the block where Reliance is now drilling and several adjacent blocks show world class hydrocarbon, plays well with 'direct hydrocarbon indicators'.

From the consumer point of view, the gas discoveries will lead to an increase in supply. The demand for gas is rising at alarming rates and the discoveries may reduce the widening demand and supply gap. The current demand for gas is estimated around 151 million standard cubic meters per day (mmscmd) whereas, the supply is only a mere 66 mmscmd of gas. The discovery of 40 mmscmd by Reliance will reduce the gap certainly to that extent. But bringing gas from the deep waters to shore will require a time period of three to four years. In the mean time, it is estimated that the demand will shoot up to 231 mmscmd—a gap of 125 mmscmd of gas. According to Madhu, the gap may be still bigger, when he says, "Domestic supplies from mature fields such as Bombay High and onland Gujarat are showing a declining trend. This means that the new supplies will go first to arrest the decline and only then move towards narrowing the demand-supply gap." Private players eyeing this huge gap and with the successful discoveries in the coming future, the bidding of blocks can gain the much-needed momentum.

What it means?

The discoveries will no doubt propel the long awaited energy security of the country. But what it means to the players? How the new discoveries are going to benefit the economy? Who will be the major beneficiary?

If the dream of bringing gas to the end-user materializes, then the Indian economy can benefit immensely. The benefit will be derived in the form of reduced dependence on imports. Though there is no solid research done to know the exact magnitude of decline in imports, the substitution effect will reduce the importance of oil imports, thus directly reducing the burden on the economy. Megha explains, "The supply of gas from indigenous sources will definitely reduce the country's dependence on imports. There will be qualitative as well as quantitative benefits. The infrastructure for gas transportation will be developed further. More players will participate in the market and ultimately the consumers will benefit."

It is not that the import bill alone will have a positive impact. Other sectors of the economy are also likely to benefit from the new supplies. One of the sectors that is going to be directly benefitted is the power sector. A number of power projects that have come in the last decade are gas-based. Most of the requirement is being fulfilled by imports from countries like Bangladesh, Myanmar and Malaysia. If gas is available domestically, then the dependence on imports will come down and the prices will also come down accordingly.

Megha adds, "The new discoveries will definitely ensure more energy security for India, as the country will become self-sufficient in resources. This in turn will help development of other sectors (power, fertilizer, cement, steel etc.), which are currently deprived of gas use because of non-availability and this will ultimately lead to development of our economy as a whole." However, Madhu expresses his doubts about the ability of the power sector to utilize the gas supplies when he says, "fertilizer and power units stand to benefit the most as they can replace costly naphtha with gas as feedstock and fuel. But most of the SEBs are sick and owe big sums of money to their fuel suppliers. So, it may not be able to take full advantage of domestic gas discoveries."

> **"Domestic supplies from mature fields such as Bombay High and onland Gujarat are showing a declining trend. This means that the new supplies will go first to arrest the decline and only then move towards narrowing the demand-supply gap."**
>
> **Madhu Nanian**
> *Editor*
> Petrowatch India

In an indirect way, adjacent states may also benefit. Since the development of the oil fields and the construction of pipelines require huge manpower, the oil fields are expected to create employment opportunities in the region. The development of the area along with the proximity may induce some states to come out with power plants with gas as fuel thus creating a demand for the supplies. Already, the AP Chief Minister Chandrababu Naidu has expressed his willingness to use the gas produced in the KG basin to meet the power demands of the state. Since there will be a lot of transportation involved, facilities in the region will also develop. One point is clear—the new discoveries have given birth to a new hope for the Indian economy and the national energy security.

Challenges

While there is no doubt that the physical delivery of gas from these new reserves will take place only after three years, the actual investment that is going to be

required for delivery is very high. Roughly $2-2.5 bn has to be incurred by RIL for developing and exploration of the gas field. If this is the cost of one gas field then one can imagine the cost involved in developing the rest of the fields in which the gas reserves are detected. For companies like RIL and ONGC, investing may not be a big problem, but the actual problem is in evaluating the viability of the fields. Opines Madhu, "As for reaching the end-user, there are big challenges. The most important one being that of finding the right markets."

Since the gas reserves are in the deep-sea bed of Bay of Bengal along the Andhra Coast, companies have to market their gas to the nearest states for economies of scale. However, in the absence of such a market, companies have to transport this gas to either northern or western part of the country. Exemplifies Madhu, "Conventional wisdom suggests that eastern India is not a viable market because there is not enough demand for the quantity of gas that could be available from Reliance. Same is the case with Orissa and for states like Bengal and Bihar, coal is a much cheaper alternative than gas from deep-water offshore. The only markets are in northern and western India."

In case, Reliance and ONGC find that the only viable markets for them are northern and western India, then transporting gas through pipelines running across the country is going to be expensive. Agrees Megha, when she says, "Infrastructure bottlenecks still exist in transporting natural gas. Reliance has proposed plans to build multi-source supply pipeline. They have plans to put up gas pipelines from Goa to Kakinada and from Jamnagar to Cuttack. GAIL too has some plans to build national gas grid in the next six to seven years This clearly indicates that huge investments are required." So, it becomes important for both the players and the government to ponder about the required infrastructure or to create demand for these markets. Until this is attempted, the benefits of these new reserves will go underutilized.

Another bigger challenge in the case of these new discoveries is pricing of gas. The exact price of gas can be known only when companies estimate the reserves and complete the feasibility study. Reliance is conducting an audit about the reserves by a Dallas-based reserves consultant Degolyer & McNaughton. The audit is trying to estimate the reserves, as to how much of it is proven, possible and probable. Reliance has to take into account these factors along with the market proximity and announce its prices. Madhu feels, "Since Reliance gas is deep-water offshore, costs of getting it to land will be much more than if it is closer to shore. In that respect, Reliance's development costs will be high. No one is sure that Reliance will quote for its gas." Megha further adds, "Gas pricing is another issue that is not unclear between the buyers and sellers and the role of regulator in this regard."

The aspect pertaining to the regulator is also one of the big challenges for the industry. In spite of the fact that APM is being dismantled, the Indian consumer is yet to benefit fully in the deregulated scenario. Megha says, "The regulatory body is required for smooth functioning of oil and gas sector with consumers/buyers getting best services from the producers/sellers at a competitive price. So, there is a need for a body to come into existence in a fully deregulated scenario." For the industry growth in the future there is a need for an efficient regulator and also a body, which can look after the infrastructure needs. In the absence of such an initiative, investment required to create the infrastructure will hamper the spirit of the players and can adversely impact the industry in the long run.

> **"The supply of gas from indigenous sources will definitely reduce country's dependence on imports. There will be qualitative as well as quantitative benefits."**
>
> **Megha Shukla**
> *Area Coordinator*
> *Tata Energy Research Institute*

Future

Perhaps, the future of Indian oil and gas industry looked bleak (with respect to exploration) few months back. The discovery of oil and acquisition of equity in Sudan has no doubt changed the perceptions about this industry. Further discoveries can change the entire face of the industry. With the fourth round of NELP bidding round the corner, the interest is certainly high. Though few more discoveries are required to achieve self-sufficiency, the path seems to be clear.

In order to capitalize fully on the gas reserves available, there is an urgent need for the government to rethink its energy security strategy. Opines Megha, "There is a need to relook at various supply options in light of new discoveries and probable projects coming through in various sectors and define an integrated energy strategy for India." For India to attain self-sufficiency, a well chalked out program like NELP is inevitable, otherwise, we may find most of the gas reserves in and around India untapped.

Y Chandra Sekhar

Reference # 1-2003-02-11

"Here lies a global responsibility to which developed countries will have to give attention and thereby put in place equitable forms of disciplines along with systems of cooperation with the developing countries."

Dr. Abid Hussain
Former Ambassador of India to the USA and
Former Member, Planning Commission

Globalization is a defining character of contemporary history. It implies expansion of human activities across political boundaries. It refers to a process of increasing degree of openness and greater cooperation between countries. It is associated not only with an increasing cross-border movement of goods and services, capital and technology but also of people, ideas and culture.

Globalization is driven by technological revolution in transport and communication which brought about an enormous reduction in time taken as also cost incurred in traversing geographical (distances) space. It is the marvels of science and technology which have telescoped time and distance and banished the brooding isolation for good. Any uncritical opposition of globalization would be counter productive.

Conceptually, globalization is a twin process. At one end it pushes the economic players to go beyond the national confines (country boundaries) to do business elsewhere on a scale never conceived of before. At the other end, the countries themselves which were hitherto existing as cloistered communities throw open their borders to let the outsiders in not treating them as invaders but as equal partners.

Globalization leads to phenomenal expansion of international flows. An increased proportion of world output reaches out to different lands in need of goods and services and also enables stock of foreign investment and technology to move to developing countries which if wisely handled, could accelerate their all round process of development. Outside forces may not *suo moto* be benignly motivated. It should be obvious that globalization cannot replete the United States. It is not a compassion driven movement. In fact, moved by lure of profit and greed, the multinationals are prone to exploit the disadvantaged, weak and poorly endowed countries. Since the process of globalization has an inbuilt advantage for the most efficient and competitively superior corporations, the process of integration could prove adverse to the interest of the less developed countries which have little political or economic clout to offer resistance to unfair deals and practices which could foreclose progress.

Be that as it may, most of the gains from international, economic integration accrue in favor of countries where most of the pre-conditions for industrialization already exist. Others, not so favorably placed experience de-industrialization, joblessness and under-development. Hence, the process of globalization remains uneven and there is no automaticity about its development process. It is for this reason that some considered the process of globalization as salvation while others regarded it as damnation. But this does not mean that developing countries should spurn the challenge of globalization by describing it as the return of imperialism by other hands. Instead, they should infact work to upgrade their productive skills, reconstruct or improve their institutional arrangements, devise policies to effectively control activities that violate the fundamentals of free trade and fair practices. They should, therefore, not be overwhelmed by the process of globalization.

What is needed is to listen carefully and discern the footsteps of history and get in step with those countries which have done well in a manner as to maximize benefits from the process of globalization and maximize risks of transition. This can be done.

Developing countries should have a strategy of a statecraft to subordinate, on one hand the global forces of exploitation and on the other, accelerate forces which would protect and serve the genuine national interests. This duality should devolve into what could be termed as GLOBALIZATION (i.e., global plus local interests combined). The art of it lies in keeping the two conflicting demands constantly in balance. Since this cannot be left solely to the devices of the market, the state has to play a dynamic proactive role which means that the developing countries should not leave things to their own devices but should take steps to counter the trends which for instance weaken the terms of trade for

developing countries and to strengthen means to counter the undesirable practices of multinationals. It is here that the national governments have to become much more active than they have hitherto been to architect an economic and political framework, administer a coherent public policy which would make the businesses both domestic and foreign to remain sensitive to socio-economic purposes and political goals of the country.

The developing state would not only have to invite foreign investments and technology but ensure that they are productively employed. Inefficient use of manpower and material leads to costly and inefficient productions which becomes a great handicap in negotiating the competitive forces of globalization. In any economy, the major sources of productive power is not just machinery, equipment building and other physical assets but it is the productive capacity of human beings which matters. Globalization demands states to make heavy investment in building human resource capabilities. Since globalized world will be a knowledge world, producing knowledgeable products, it needs knowledge manpower. In this context, digital divide for instance would prove disastrous.

When we assert that globalization should not be at the cost of developing countries, we mean a significant role for the state in such countries. Not weakening of the state or liquidation of sovereignty as is generally believed. States can not abdicate their social and constitutional responsibilities. In this context, the state intervention should not be deemed as a primitive force opposing a progressive process. Increase of production and pursuit of social goals are the necessary characteristics of a modern state. If this is not taken care of by a state, only a narrow segment of population may be integrated to profit from globalization while a large percentage of people will be marginalized even further. The state supported professionals would also be tempted to leave the country instead of serving it for petty jobbery in the west or at best become salesmen of toothpaste, talcum powder and credit cards, etc., at a great cost to countries' investment in them. As the saying goes, "information technology would be almost useless to an economy that has no other strength," it is therefore wrong to assume that globalization implies a weaker state and leads to diminution of sovereignty of the state. In fact, pooling of sovereignties and assertion of a state would be the logical demands of globalization. Well defined rules of the state intervention will no doubt have to be worked out though the quality of intervention has to be different.

Institution reforms in WTO and other world bodies should also be guided by values of democracy and equity

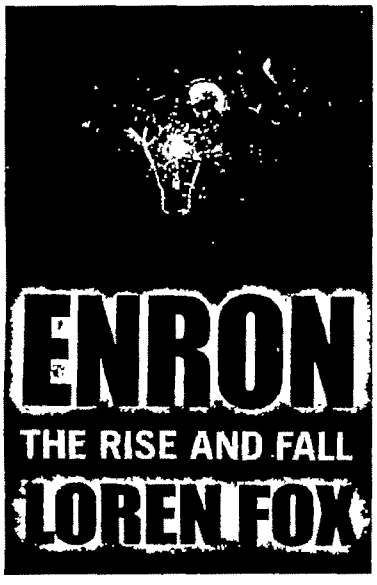
Globalization has implied imposition of certain conditions relating to social causes, environment considerations, etc., which could prove detrimental to the interests of the developing countries. There is already enough evidence to indicate the grounds swell of protest against these. This could be ignored only at a great cost to the developed countries themselves. These and connected issues have to be satisfactorily resolved at international front and also at bilateral levels which help to avoid the debacles witnessed at Seattle and Geneva which nearly derailed the process of globalization.

Bonds of mutual interest have to be worked out around a sustainable constructive program of action between the developed and developing countries and between forces of nationalism and sub-nationalism which globalization tends to fuel. Different cultural and religious identities have to be respected but they should not be allowed to fuel fragmentation and disharmony, dismantling the framework of national unity. It is necessary that a global code of conduct is worked out to counter balance the disrupting forces and processes of societal transformation. The developed countries should realize that in history many societies have collapsed when they seized to be virtuous and single-mindedly pursued their narrow selfish interests unconcerned with the consequences of their action. Here lies a global responsibility to which developed countries will have to give attention and thereby put in place equitable forms of disciplines along with systems of cooperation with the developing countries. Institution reforms in WTO and other world bodies should also be guided by values of democracy and equity.

The time has come when a dispassionate assessment of globalization should be undertaken on a priority basis. Future discipline should be decided in accordance with the finding of such assessments. Equally important would be for the developing countries to undertake imperative studies to identify the negative factors which in their perception have de-established their society and distorted their economy. Since potential for growth and progress of developing countries still continue to be in far excess of their achievements, there is a legitimate room for hope.

It is the supreme task of statesmanship for our age to create the elements for mutual dependence, a new dedication to positive collaboration and in this way to turn the challenge of globalization into a powerful positive force for world cooperation, order and progress. Thus to bring about a world order, we have been trying to build up over the past few decades.

Enron
The Rise and Fall



Author **Loren Fox**
Pages. 357
Price Rs 1270
Publisher John Wiley & Sons

The tragic debacle of Enron is a defining event for today's generation of business professionals. The author unravels one of the big downfalls in the history of corporate America and lays bare the toxic confluence of innovation, greed, and hubris.

The word 'Enron' has officially entered the American vocabulary—not as a symbol of excellence and innovation that Chairman Kenneth Lay envisioned but as the corporate embodiment of greed, excess, and unprecedented fraud. Never in history has one company plummeted so quickly from the heights of power and glory to the depths of public humiliation, bankruptcy, and criminal investigation, dragging so many individuals and firms down with it.

Pipeline to profit

Enron's failure was anything but typical; it was one of the most thrilling rise-and-fall of recent years. Enron took its form in 1985 from a merger to become the US's largest natural gas pipeline distributor. By the mid-1990s, Enron was establishing power generation ventures both in the US and internationally. Starting in 1985, Enron grew in a decade and a half from a large natural-gas pipeline company to an energy-trading firm that bought and sold gas as well as electricity. In the late 90s, Enron had even evolved beyond energy trading, trafficking in metals, paper, financial contracts, and other commodities. By that time, so much of its business came from trading, that Enron had essentially stopped being an energy company and functioned as a kind of bank. That transaction spurred massive expansion, so that from revenue of $4.6 bn in 1990, Enron grew to $101 bn in revenue in 2000 that made Enron the seventh largest company in the US, bigger than IBM or Sony.

The company, at its level had more than 20,000 employees and operations in 40 countries, pioneered real innovations. Lay and other top executives featured on the covers of business magazines, and the company was hailed as a model for innovation. The Enron story, with all its moving parts, is not only a tale of genuine achievement, but also of arrogance, ambition, and deceit. It is the story of how so many people and agencies missed the

cracks in Enron's facade, in part because the system was set up that way.

Enron was a child of deregulation. Although Enron's domain would later expand to include electricity and electric deregulation. For gas, deregulation in essence, allowing some free-market competition into an industry that had been strictly regulated by the government—didn't happen in one dramatic stroke of a pen, but in a series of steps. The first step has been the 1978 deregulation of gas prices. In the early 1980s, gas producers were selling much of their gas at market prices, although there was an oversupply of gas. Then in 1985, a second step was taken in gas deregulation. This order essentially encouraged pipeline companies to voluntarily make their lines available to all gas utilities, which means that local utilities could buy gas from the producers and then pay the pipeline just for transporting the gas. It meant pipeline companies had to separate their businesses of gas transportation and gas sales. Against this background, pipeline companies continued to merge. Enron was going to move into uncharted waters that would eventually change the company and the gas industry.

The Enron story, with all its moving parts, is not only a tale of genuine achievement, but also of arrogance, ambition, and deceit

Where is the money

Kenneth Lay had thrown down the gauntlet for Enron. Deregulation was splitting the gas industry into a regulated business and an unregulated business, and the growth opportunity was in the unregulated side. Gradually, Enron's pipeline began specializing its function, focusing on transportation only; the gas sales business was moved to another division. Because much of this business was catch-as catch-can and Enron was truly acting as a free-agent merchant of gas.

About the Author

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Enron's gas sales business gave birth to its gas trading business. It bought and sold standard amounts of natural gas—the way stock trading might involve buying 100 shares of stock in the morning and then selling those shares at a small profit that afternoon. Enron's gas trades also followed a longer timetable. By the late 80s, Enron was making deals for a month's supply of gas or several months' supply. By 1990, the spot market accounted for more than 75% of gas sales, which increased gas price volatility. Spying that there might be demand for longer-term deals; Enron offered a range of 2-to-10-year contracts with fixed pricing. By offering customers greater reliability, Enron could also charge a premium for its services; profit margins were higher than on long-term deals than on spot-market deals.

Buying and selling gas was just one piece of the puzzle. Enron also wanted to trade financial contracts based on the price of gas—in a word, 'derivatives.' Derivatives are financial instruments—often akin to contracts—that derive their value from some underlying asset. Although derivatives can be too complex, millions of ordinary Americans are familiar with one of the most fundamental derivatives—options. Thanks to the growth of ESOPs over the past decade. An employee of Enron might have options to buy 100 shares of Enron stock for $20 per share, and those options might expire in three years; if Enron's stock is trading at $30 per share within those three years, the employee would do well to choose to cash in the options, but if the stock is trading at $10 per share, the employee could choose to let the options expire unused rather than overpay for the stock.

So Enron wanted to get into financial trading to complement its physical trading. To do so, the company partnered with Bankers Trust, a well-known New York bank with derivatives expertise. The goal was to use options and other bets on prices using purely financial means. This meant that aside from securing a supply of gas, Enron would be using derivatives to lock in prices, or at least lock in maximum and minimum prices.

During the early 90s, Enron was turning into a pipeline-and-finance company, and Kenneth Lay wanted help with that transformation. He got help, and a jolt of new energy, on June 26, 1990, when hired itself a new chief executive for its Enron Finance unit called Jeffrey K Skilling. When he arrived at Enron, Skilling was bright, confident and driven. But he wasn't yet the charismatic leader who would rise to be the CEO of Enron in 2001. Lay describes him as a strategic thinker who always came up with new ideas. But the patriarch of Enron also admitted that Skilling wasn't able to relate well to most other employees. Even Lay could tell that some staff felt Skilling talked down to them. In the early 90s, Skilling worked to remake Enron into a new entity which was ready for the energy industry of the 90s.

The trading business fueled Enron's growth by the start of the 90s, had a market capitalization—the value of the company based on its stock price—of $2.65 bn. That rose to a market value of $8.26 bn at the start of 1994. As a public company, it felt a responsibility to maintain a healthy rate of growth. But because of mark-to-market accounting, a sizeable portion of

Enron's growth depended on a rising volume of deals. Its growth was slowly turning into a momentum monster that needed constant feeding.

Major ambition

As the middle of the 90s approached, Enron had turned itself into the biggest trader of natural gas in the US. But the trading business didn't dominate the corporation. The company simultaneously concerned itself with expanding its 'hard' assets, like pipelines, oil and gas fields, and natural gas—fueled power plants. At that time, these were not contradictory goals. Enron was trying to become an integrated gas company, with operations in producing gas, delivering and selling gas, and trading gas.

Beyond being viewed as a multifaceted company within the US, Enron also wanted to have an international presence. This wasn't just a matter of pride. American energy companies had always taken an interest in foreign properties, whether in drilling for oil or in helping to build pipelines and power projects. Enron's highest-profile foray in the international arena in its early years was not all that successful, to say the least. The company had a unit called Belco Petroleum Corp., of Peru that explored for and produced oil and gas in that country. But in 1985, Peru's populist Government seize US oil holdings in the country and nationalized them, including Belco. Enron suffered a $218 mn loss as a result of the nationalization of its Peruvian unit.

Enron was not discouraged by the Peruvian experience. Large gas companies besides Enron were looking to internationalize. In some ways, London's British Gas had sparked the competition at the end of 1990 when it acquired a local gas utility in Ontario, Canada, and then began touting itself as the 'first global gas company.'

Rebecca Mark was not a typical Enron executive. For one thing, she was a woman, and while Enron didn't discriminate against women, it was still unusual for a woman to rise to high levels in the energy business. Under Mark, Enron Development Corp., fashioned itself as a group of capitalist cowboys who were spreading the gospel of capitalization of free markets to developing nations. By 1993, Rebecca Mark and Jeff Skilling were rivals of a kind. Although they were colleagues, both were jockeying for Lay's approval. They also represented different sides of Enron. Skilling oversaw 'asset-light' businesses, such as trading and finance. Mark's job was to literally build more hard assets that Enron would own or co-own. At this stage, while both of these competing visions were growing, the rivalry was subdued. But it would get hotter. Mark's biggest test came in India, where Enron pursued its biggest and most controversial foreign project.

Snapshot

- The speed of Enron's rise and fall is truly astonishing and perhaps is the single most important story of corporate failure in the 21st century
- As Enron's success continued, it bent the rules more and more, somehow staying within the loosely defined parameters of accounting Eventually, it seemed like a small leap to make from bending the ruled to breaking them.
- There was no single movement when Enron transgressed from rule bender to rule breaker; rather the transformation resulted from the gradual accretion of offenses, encouraged by a corporate culture that valued aggression
- Energy deregulation wasn't responsible for Enron's collapse. In truth, deregulating the gas industry resulted in billions of dollars in savings
- The fallout, though will stretch well into 2003

Electrifying opportunity

While Enron busily made its presence in various foreign locales, the company continued to grow in North America and as a whole. In 1993, the company reported net income of $386.5 mn, excluding a one-time charge related to taxes, which was up by 26% from 1992's earnings. Revenue for 1993—totaled $10.1 bn, it's debt situation also looked better. Enron's stock was also doing well. As a result of all this accomplishment, Enron started to grab headlines outside the energy industry. Flattering profiles appeared in *The Economist*, *Business Week* and other publications. This success wasn't lost on the rest of the business world. Competitors followed Enron's lead into gas trading and finance.

As the gas trading operation grew, Enron began its first extensive use of SPEs. An SPE is simply a trust created by a company to hold some of the company's assets; typically, the SPE would then either borrow against those assets or conduct more complex financing arrangements backed by those assets. Because the SPE contains some assets but none of the company's existing debt, it's a less risky borrower and can therefore borrow money at lower rates.

Natural gas trading was obviously a success, and Enron was looking for another energy commodity to which it could apply the same system. Although Enron traded crude oil, that commodity didn't fit the bill the way gas did. But electricity was another matter. Enron wasn't the very first company to trade electricity, but the company recognized that it could serve as a middleman in this business. The key to Enron's trading was volatility. The more volatility the energy prices, the more opportunities for Enron to make money.

Culture of creativity?

Even before Enron plunged into trading, Kenneth Lay had sought to shake up the company's stodgy, hierarchical culture. "We really

didn't run economic models. We ran cost estimates, and then we spent all of our time analyzing whether we could convince regulators that it was a just and reasonable investment." As the revolution of Enron continued, Skilling became the single biggest factor in a determined effort to reshape Enron's culture, starting in the early 1990s.

The company wanted to create an organization that resembled more of a Wall Street firm or consulting practice. Hence the alliance with Bankers Trust, and the hiring of people from Salomon Brothers and other investment banks. By the mid-90s, the company had become one of the top recruiters of MBA grades among non-financial companies. Lay not only supported Skilling's efforts, but he firmly believed in paying top dollar for top minds. It was an outgrowth of his hands-off management style, in which he found a good person to run a division and then let that individual run it.

One of the most important and controversial of Enron's organization was its system for assessing employees' bonuses and promotions. Beyond a culture of traders, Skilling had also brought much of the McKinsey culture with him. His tenure at McKinsey & Co., one of the most prestigious consulting firms in the world had given Skilling a taste of a meritocracy. Despite the company's attempts to hire a mix of men and women, Enron had within it a boy's club typical of trading rooms that reveled in rowdy times involving members of the opposite sex and strippers. Not surprisingly, sexual hi-jinks resulted in rumored sexual harassment complaints from some female employees.

Taking the plunge

Enron's sale of a stake in Enron Energy Services (EES) to CalPERS held significance beyond just setting a value on the new business and finding a partner to share some of the new business costs. It sparked the first instance in which Enron used SPEs run by company employees to engage in questionable accounting, starting the trend that eventually led to Enron's collapse. Enron had a real need for a healthy balance sheet. The company's trading business and overseas developments required reams of cash, and Enron was a frequent borrower, issuing bonds or debt securities.

Growth meant new markets. When Enron entered a new market and turned the product there into a tradable commodity (say, electricity), it would reap fat product margins. But as the market matured, the profit margins would slowly shrink. So as competition made the market more efficient, the profits would shrink—the way commissions on stock trading gradually declined from around $300 per trade to $50 per trade to $30 or less. The sort of attention to detail that Enron once displayed seemed to have faded.

Downward spiral

Enron may have used SPEs such as the Raptors to enhance its earnings, but they weren't the only strategies the company used for financial results. Chief among the company's income-boosting tricks were two other important tactics; reducing tax costs, and hiding loans as derivatives transactions known as 'prepaid swaps.' Enron used the prepaid swaps because they kept the financing from its official debt, allowing the company to retain a decent credit rating. But it seemed significant enough to rating agency Moody's, which put Enron debt on review for a possible downgrade because of the valuation write-downs and changes. The business world slowly lost confidence in Enron, and confidence may have been its most prized asset. As with any trader, only the assurance that Enron could back up its deals persuaded others to trade with it. But with confidence eroding, the liquidity started to disappear.

As its financial condition grew more precarious, Kenneth Lay altered top federal officials. He didn't ask for government help. Instead, he offered to have Enron executives speak with Treasury officials about the extent of Enron's troubles. Enron's next steps were obvious. It gathered its lawyers to assemble a list of creditors. On December 1, Enron's Board met and approved a notion to declare bankruptcy. The next day, using the Internet, Enron electronically filed for Chapter 11 bankruptcy protection. Lay's dream of creating the world's leading company was dead.

Endgame

In filing for bankruptcy, Enron listed assets of roughly $62 bn, making it the largest bankruptcy in US history at that time. The results were dreadful. If there was any mudslinging, perhaps it was inevitable given that Washington was equally awash in mud. Investigations into Enron proliferated. Several congressional committees held hearings. The bankruptcy process continued, and it wasn't cheap. More than two dozen law firms handled various parts of Enron's bankruptcy case. Despite the infighting, the uncertainty, and the employees were sad not just because they were leaving regular paychecks. Many missed the autonomy they were given, the camaraderie of smart, driven colleagues, and the freedom to be creative. The author concludes that Enron provided the biggest example of corporate malfeasance, but it marched at the head of a long parade of business misdeeds. In sum, whether dealing with securities laws or energy regulation, with corporate governance, the message is clear: Capitalism is a complicated enterprise, and the system won't work without referees.

N Janardhan Rao

Reference # 1-2003-02-12

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For research activity	❑	❑	❑	❑
For examinations	❑	❑	❑	❑
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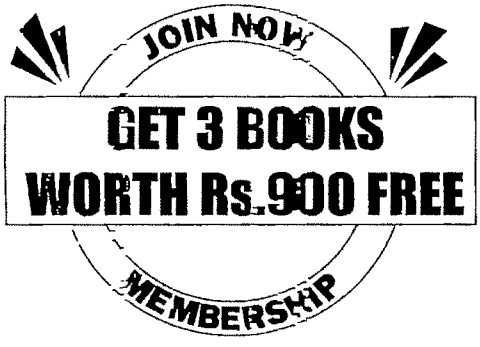

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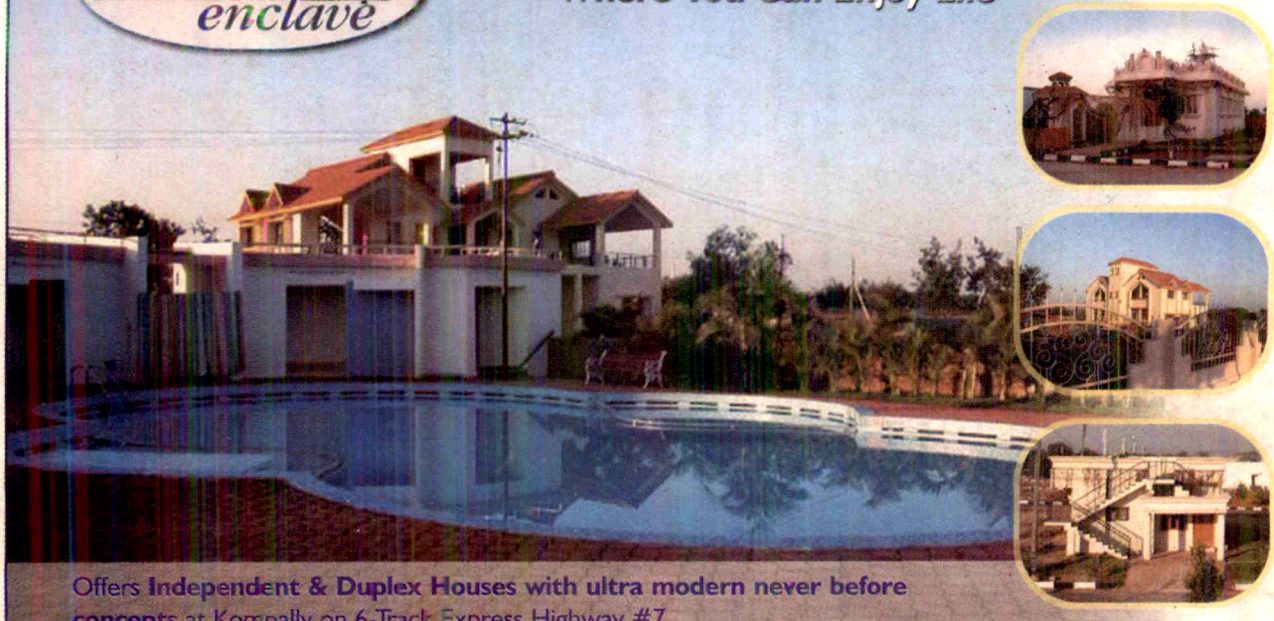

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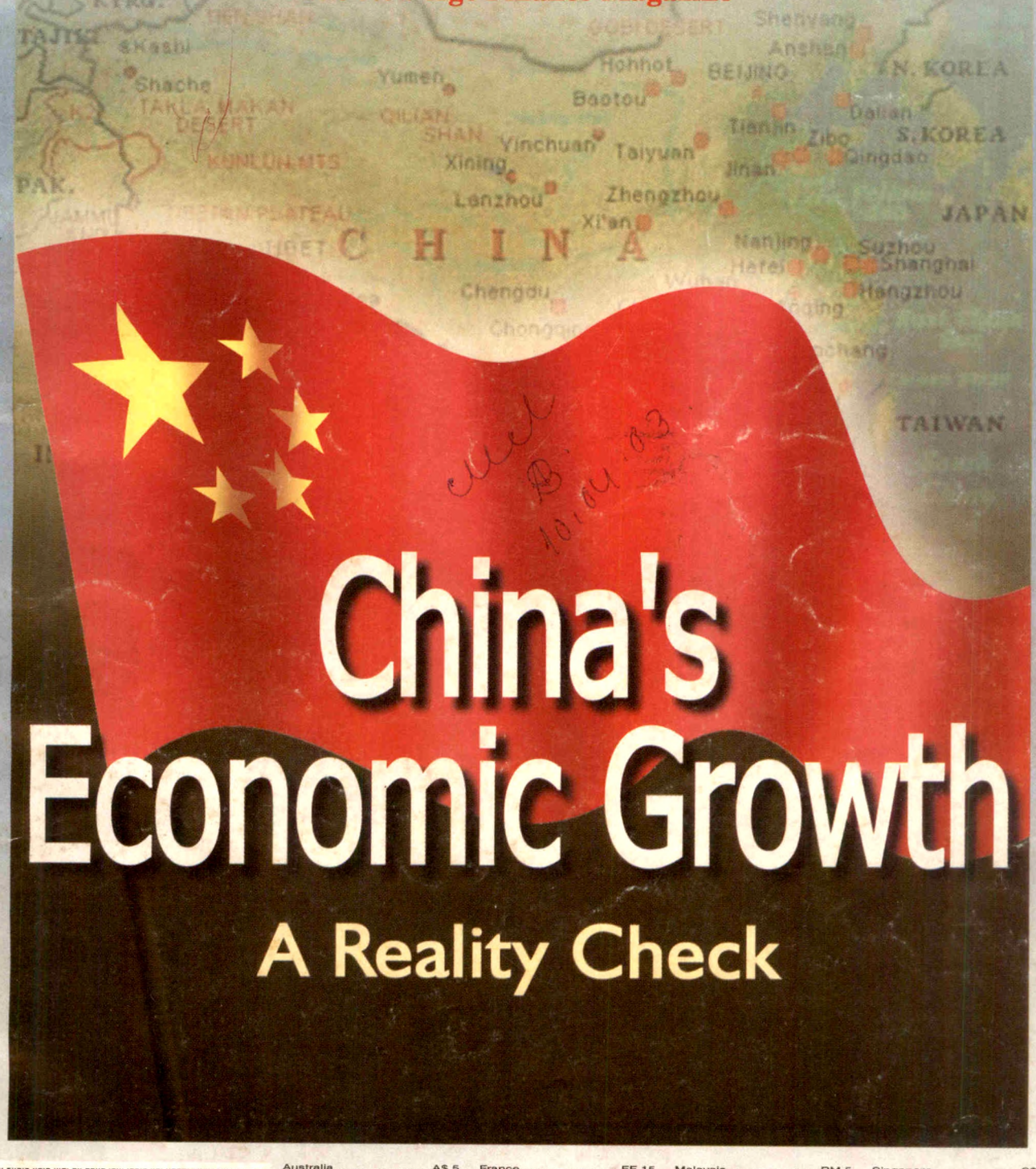
April 2003 The New Age Finance Magazine Rs.60



China's Economic Growth

A Reality Check

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Vol-IX, Issue - 4 April 2003

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ISSN 0972-5053

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Printed and published by E N Murthy on behalf of The Institute of Chartered Financial Analysts of India, ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta Hyderabad-500 082 Andhra Pradesh Printed at M/s ICIT Software Center Pvt Ltd (Press Division) 3-112, Fatehnagar Sanathnagar P.O., Hyderabad - 500018 Andhra Pradesh and published from The Institute of Chartered Financial Analysts of India ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta Hyderabad-500 082, Andhra Pradesh Editor E N Murthy

Enter the Dragon

Ever since China embraced an 'open door' policy in 1978, aimed at encouraging international trade and foreign direct investment, the country's economic growth has been truly remarkable. With the GDP growing at a rate of 10%, the country's economic progress is beyond serious dispute. Leveraging its cost efficiency, owing to cheap labor, the country has emerged as the new manufacturing hub of the world. After decades of exporting mostly low-end products, such as textiles and toys, China has, of late, moved into more sophisticated, high-tech products like computers, TVs, and DVD players. For large US retailers such as Target Corp. and Wal-Mart Stores Inc., China has become a huge spigot of supply. About $10 bn worth Chinese merchandise makes it to Wal-Mart stores every year, either directly from manufacturers in China or from other suppliers that tap sources in the country. Even in industries such as auto and telecommunications, the country is on its way to establish its might as it attracts world's leading manufacturers to set up their bases there.

For India, China could be a good example to learn from, in order to play a significant role in the world economy. Many see China's manufacturing might as a threat but that need not be the case. India has carved its own niche in the field of IT and IT-enabled services, and is on its way to replicate that in the field of pharmaceuticals and biotechnology as well. In a way, India has begun doing (albeit in a small way) to the world what China is already doing in manufacturing. India, which remained untouched at first by the industrial revolution wave, and then by the manufacturing wave, is all set to make big strides in the global IT and services.

Though India's status as world's outsourcing destination is now firmly getting established, it has largely been providing low-end IT services to the world so far. It would be desirable that the domestic technology companies raise the bar and make their way up the value chain. However, this would not be easy. This would require vision, ability to take risk, and more appropriately grit to excel at international level. Perhaps India can also learn some lessons from countries like Singapore, which have emerged as global hub for financial services. In fact, India's so-called success in IT and IT-enabled services pale in comparison with what its Asian counterpart has achieved. In a manner of speaking, what the successes of countries like Taiwan, Korea, and Singapore suggest is that countries should focus on their core strengths, develop their business models, analyze their relative strengths and weaknesses just as companies assess their SWOT and leverage on their strengths, instead of feeling threatened by competing countries. Perhaps that would be a better way to achieve prosperity.

Ch Rajeshwer

Letters to the Editor

Good Depth

I am a regular reader of the *Analyst*. The content is quite interesting and of good depth.

Chirag Gokani
chiraggokani@indiatimes.com

Reliance: Bringing Revolution

The cover story on the Mobile Wars in India was very informative and interesting. Reliance with its big bang entry into the mobile field has forced all the players to move fast and slash prices. Even the state-held telephone players have moved to slash their prices. My question is if they are able to provide service at cheap prices now, were they not cheating customers till now? May be that is why they say that customer wins in a competition.

T Maheshwari
Hyderabad

Resolving the Issue of NPAs

The debate on the Securitization Bill made a good read. Coming from the scions of the industry who are actually tackling the issues in its implementation, it provided a lot of new insights into the advantages and disadvantages of this idea.

V Shanker
Thiruvananthapuram

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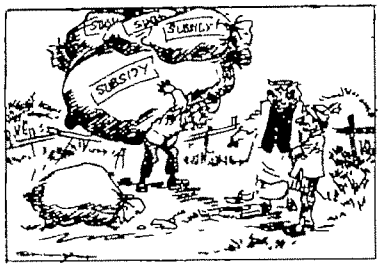
Cartoon Corner

YOU SAID IT by Laxman



Pick it up, Jaswant! Surely you don't expect this poor chap to carry it!

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Verbatim

The biggest casualty of the upcoming war with Iraq may be the US economy. A dramatic increase in debt could result in a fall of the dollar that would reduce US living standards while significantly increasing the cost of projecting US power abroad.

Clyde V Prestowitz Jr, President Economic Strategy Institute, (US) and author of the forthcoming book Rogue Nation, *on the implications of Iraq war.*

No one will, in future, be allowed to put up his feet at the expense of society.

Gerhard Schroder, Germany's Chancellor on the reforms for ailing German economy

The objective is not oil, but in the broad equation you cannot ignore oil.

Nader Sultan, the British-educated CEO of the National Kuwait Petroleum Corp (KPC) on the reasons behind the Iraq war.

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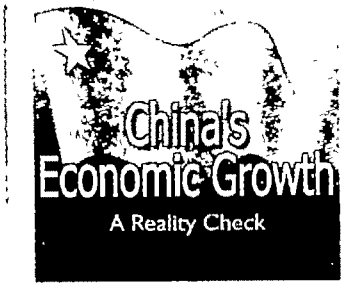

Cover design by Bangaru Babu A

China's Economic Growth: A Reality Check 19

It is the new 'workshop' of the world. Undoubtedly, the dragon has successfully conquered the global manufacturing turf by churning out low-cost, however, quality goods, catering to consumers across the globe. China's growing influence in manufacturing is being seen as a threat by many experts and nations. According to critics, however, there is more myth than reality about China's miraculous growth story.

SPOTLIGHT

SHORT-SELLING

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As stock markets continue to be in a flux, critics look keen to put the blame on some one, and the scapegoat is short-selling. But the question is – will the market be better off without them?

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Given the turbulent stock market conditions and pessimistic predictions, many companies are now considering it worth to go private than remain public.

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The next big trend in Wall Street seems to be driven not by a new new thing, but the old-fashioned notion – that healthy dividends are a sign of superior corporate prospects.

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E G Ross, Editor, *The Objective American*

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Curbing Short-selling: Lessons from History

Just about a couple of years ago James Chanos was not a very familiar face on the Wall Street. However, post-Enron, he enjoyed a special status as the bear who correctly saw Enron's coming collapse. Post-Enron, many short-sellers like him enjoyed the limelight for successfully predicting doomsdays for several of yesteryears' high-flying stocks including WorldCom and Global Crossing. However, their newfound status is also causing them a great deal of trouble. As the markets continue to simmer under a long bout of downtrend for over two years now, these very short-sellers are under market regulators' lens for causing turmoil in markets. There are talks on tougher rulers to be introduced by the SEC, the US market regulator to curb the growing abuse of short-selling on Wall Street. Some fear that this could even mean a total elimination of short-selling.

The question, however, here is—why just punish the bears? If bears are guilty for pulling down valuations to rock-bottom, then, by the same yardstick, bulls also share the blame for helping stock prices shoot through the roof. As the failure of several dotcom companies show how equity analysts and stockbrokers put egregious valuations on the stocks and misled the gullible investors in believing that millions can be made out of nothing. After the dotcom bubble has bust, investors in many of these start-ups are now left with nothing but useless papers. When the dotcom hype was building up, no one asked any questions. Regulators too did not seem to bother much. But with the benefit of hindsight, perhaps, short-sellers had seen it all coming. James Chanos was among the first few to smell a rat at Enron and go short on it. Tyco, another case of accounting malfeasance, was first spotted by David Tice, much before the markets discovered it. Manuel Asenjo, one of the most prominent short-sellers on the Wall Street and argues that once short-selling isn't about betting that good companies will fail or try to profit from the misery of others. He observed that short-sellers play an important and necessary role in the market by correcting misallocations of capital that disrupt the economy.

Historical evidences suggest that every time regulators tried to put a brake on short-selling they had to retreat. According to Kathryn Staley, author of the book *The Art of Short-selling*, short-selling was banned in Amsterdam during 1610, and then again in Great Britain during the South Sea Bubble in 1720, in France at the beginning of the revolution, and in the US during the War of 1812. All those bans were eventually repealed. It is time that market regulators learnt a lesson or two from history.

Amit Singh Sisodiya

Schröder's Remedy

The growth rate of 0.2% in German economy and the forecasts of a poor performance only added to the woes of economists. The recession in the US economy and its contagion effect has pushed the prospects of recovery into unknown future. The uncertainty over a second Gulf War only adds to the depressed moods across the world. In such a scenario the poor economic growth registered by world's third largest economy comes as a severe blow to the recovery prospects of the global economy.

Structural problems

Germany has been a growth engine for the European Union all through the 1990s. Today it cuts a dismal picture with high unemployment rates, sticky labor markets, problematic banking system, poor demand and higher taxes. Germany's higher (when compared to other nations) tax regime with better social benefits is hampering growth. These factors hamper both savings and spending by the public thus pulling away the demand side thrust to growth. In addition, the increasing unemployment rate is a severe dampener. Germany had enjoyed good exports in recent years but the appreciation in euro as against the dollar could adversely affect this advantage. In addition the recession in the US markets, and the not so prospective economic conditions elsewhere could reduce exports. Obviously, in a downturn other countries would not really spend on exports.

Germany's membership in the EU brings with it a number of strict covenants including a certain acceptable level of fiscal deficit. In an effort to rejuvenate the economy the German Government has already crossed the limit of 3% and might face hefty penalty for this.

The reform package

Finally, the German Chancellor, Gerhard Schröder has announced a reforms package on March 14. The package promises to cut welfare costs, ease labor-market laws and stimulate small-business growth that come as a desperate attempt to save the economy from the brink of recession. The main attractions of the plan include cutting down unemployment benefits and making job contracts more flexible. As part of the plan he also proposes to provide €15 bn ($16.3 bn) as loan to small companies. The problems of Germany had been in the making for long but there was no political will to take on unpleasant economic reforms. But now, the situation has further deteriorated and it is the state of the economy that could decide the fate of Schröder as well as the future of Germany.

D G Prasuna

Googol for Google

Battles on Internet turf are not meant for faint hearts. Or, so the dotcom rubble shows. They are for die-hards, those who never say never again, those who want to be in competition irrespective of the hurdles on their way. Amazon has shown it successfully. e-Bay and Charles Schwab have had their own success stories to tell.

Google, the company which aptly derives its name from the word Googol, standing for one followed by hundred zeros, is fast emerging as Internet's one of the most spectacular success stories. Like the word Googol, the company has been able to expand the list of its users almost infinitely. What makes Google so successful in search space? It lies in the search engine's ability to provide an answer (to a query) that it is unique to the user and uniquely useful. And because Google, as the company's founders say, does this better than any other online service, Google users have made it the fastest growing, most used search engine in the world. In fact, the pace at which the company has conquered the search space has mesmerized not just the critics but its competitors as well. And the company does not stop here: It is straddling many other new, albeit unrelated areas like Web-text publishing, or blogs for short, and context ad space. Though this has been of concern for critics, the company's success speaks for itself.

Google's unprecedented success comes as a relief for several battered Internet start-ups, who met with utter failures and had to ultimately retreat from the battle turf. For hundreds of Web aspirants it is a lesson that it is just not enough to have million dollar ideas, it requires the character, the determination, the grit, and the vision to convert those ideas into money churning machines. Otherwise, why the old guards of the search business like Infoseek and Lycos had to flounder. Even the yesteryear's top gun of the Internet world, America Online or AOL has now been struggling to stay afloat. Similar is the fate of millions of Internet start-ups, which sprang up during the bubble days. On the other hand, companies like Google and Yahoo!, perhaps the most successful Internet portals today, have not just survived but also thrived; Yahoo! has recently made a successful turnaround after having struggled for a brief period just a few quarters ago.

The lesson from Google's story is that it is just not enough to engage in a battle; one needs to constantly keep on developing new armories to stay fit in the battleground. For, the war in business, or more appropriately on the Internet battleground is an endless affair: You win the battle today, and get ready for another the very next day. And, in search business, it is Googol. Battle infinitely.

Amit Singh Sisodiya

Corporate Scandals of Basic Human Instinct

Last year saw a number of top American companies—Enron, WorldCom, Tyco to name a few, involved in some of the worst ever scandals like accounting malfeasance showing better results than what was actually achieved. All this in a country, which has the best-policed markets. As more and more companies came up with the earnings restatements, it was evident that most of these companies were from the United States with hardly any major European company in the list. In America, more than 1000 companies have been forced to restate their accounts in the past five years whereas in Europe this number was barely in double digits.

The Europeans claimed that this problem of earnings management is endemic to US as it suffered from some peculiar and unique challenges. The US corporate world is marked by a lethal combination of greedy overpaid bosses and conflicted auditors. The corporates follow US GAAP which relies on accounting rules not principles. And finally to top it all there is widespread obsession with quarterly profit numbers.

Though these views are indisputable it was always arguable that the European companies are not far away or immune from earnings management. This came to light when Royal Ahold of the Netherlands, the world's third-biggest food retailer said that it had overstated its profits for 2001-02 by as much as $500 mn. Ahold's accounting problem mainly involved its American subsidiaries that it bought in a decade-long acquisition binge. The company's Amsterdam-based auditors, Deloitte & Touche, failed to identify the problem in 2001 even though worries about Ahold's accounts were widely expressed in the markets for most of last year. On its part the Dutch market regulator admitted that it had no powers to discipline faulty auditing.

This proves that no country or region can be immune from corporate scandals especially in Europe which is known largely for non-existent regulation of auditors and poor corporate governance. But perhaps these scandals do not come to light mainly because nobody has seriously looked for them and not because they do not exist. The Ahold episode can be a tip of the iceberg for European corporate earnings management and only time will show the full extent of the problem and that too when someone looks for it, otherwise they would just be wrapped up in the corporate carpet and the world will come to know only when the carpet is dusted. Perhaps, it is wrong to assume that the basic human trait of greed is confined only to national boundaries.

D Satish

Indian software industry: Bright future

Watts Humphrey, a noted software expert from US, predicted a bright future for the Indian software industry, but feared that there was likely to be a shortfall of nearly 250,000 software professionals by 2008. He called for adoption of personal software processes and team software processes which, he says, were disciplined ways of software development activity. Adoption of these processes would increase the productivity of individuals by 20 times. This would result in filling up the gap in demand for software professionals in future. Software products should be warranted by their suppliers in the same way as other products and software users needed improved protection. This, he said, was possible by adopting Personal Software Process (PSP) and Team Software Process (TSP). He says 'though many Indian organizations had started adopting PSP and TSP, and getting certified through CMM levels, a more realistic result could be achieved by introducing these software quality processes in the universities in undergraduate or postgraduate levels of computer application"

Corruption on the rise

A survey by Hong Kong-based research group, Political & Economic Risk Consultancy Ltd. (PERC) has found that corruption in Asia is getting worse. Corruption in more than half of the countries covered in a survey was deemed to be worse this year than last year. "Corruption is perceived to have worsened as a problem in the past year in seven of the 12 Asian countries covered," the group opines. The survey of 1,072 expatriate executives working in Asia found Indonesia was seen as the most corrupt country, with a score of 9.33 out of a possible 10, although that was better than last year's score of 9.92. Corruption was seen to be getting worse in India. Singapore maintained its billing as the least corrupt, with its best ever score of 0.33 in the PERC survey, which was first issued in 1997. The city-state, known for its efficient bureaucracy, scored a rating of 0.90 last year. PERC says the survey only measured perceptions among business people, and was not necessarily a reflection of reality.

Running out of stream

Family businesses the world over don't have a very long life; according to professional services firm Grant Thornton. "Less than 10% of family businesses make it to the third generation and less than 50% make it to the second generation, as per our estimates," says Grant Thornton, International Divisional Director (Asia Pacific) Gabriel R Azedo. In other words, less than 10% of family businesses retain their original form and structure up to three generations of the business being founded. The others either get taken over or get professionalized with the family losing control.

In some cases, these businesses even become extinct within this time-frame. Grant Thornton had recently come out with global study on family businesses which says that while businessmen the world over are handing over reins to professionals, retaining control over business and passing it on to the next generation is still the driving passion for most Indian businessmen.

Nasdaq eyeing India

India could become a dominant foreign presence in US equity markets. Nasdaq Stock Market Inc. executives and the No. 2 US stock market wants to take advantage of that growth. "Something really significant is going on in India," says Alfred Berkeley, a Nasdaq Vice-Chairman. "We don't want to miss what's going on." The growth of India's technology and technology-related industries presents an opportunity to attract new listings to the Nasdaq. As those companies grow, they will need more capital to fund their expansion plans and listing their shares on the Nasdaq will help them access the US capital markets, the executives adds.

The super savings account

Bank of Baroda is in the process of managing a customer-driven IT-enabled business transformation. A host of interventions have been triggered to reposition the bank as a financial origin of first choice. Product innovation based on extensive market research has always been a winning strategy for the bank. In the process, the bank has launched another new product on retail liability side. The product is a superior savings bank account offering unmatched value propositions to high- and mid-segment customers.

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INTERNATIONAL

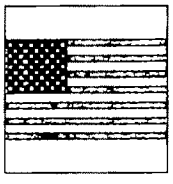
Water – Turning thirst into trade

Water promises to be to the 21st century what oil was to the 20th century. There are great business opportunities and big money to be made in what has been hailed by the European Bank for Reconstruction as "the last infrastructure frontier for private investors". The global water trade is estimated at RM3.04 tn by the World Bank, while a 10-part study released last month by the International Consortium of Investigative Journalists (ICIJ) put the potential revenues from managing water utilities as high as RM11.4 tn.

The big two French water conglomerates, Vivendi and Suez, are already delivering water and sanitation services to more than 200 million people in 150 countries. The World Bank believes, it is just a matter of time before water will be moved around the world as oil is now. Entrepreneurs are preparing for the day when bulk water can be exported in super tankers or in huge sealed bags from water-rich areas to parched regions. Plans are also being drawn to construct pipelines and dig canals to carry water across borders.

The World Trade Organization is pushing for the removal of barriers to the free flow of trade in water. Leaked documents published on The General Agreement on Trade in Services (GATS) revealed the detailed requests made by the European Commission to 29 countries, including Malaysia, for commitments to provide market access and national treatment in services such as water and wastewater management. GATS is forcing countries to open up their water sector to global water corporations, thereby accelerating the commodification of water and privatization of public water services all over the world. In the coming years, the water crisis is taking a toll worse than any war. More people are likely to suffer and die this decade from lack of clean water than from all armed conflicts combined. This should be widely regarded as one of the great tragedies of our time.

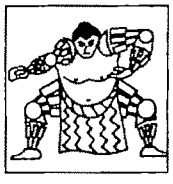
Threat of war hurts US brands



If the US does invade Iraq, some of the first casualties may be the cachet that American brands and products have enjoyed around the world and the globalized marketplace they helped to build. In Muslim countries, franchised stores like McDonald's and KFC have already been attacked, threatening to brake a recent surge of investment in franchised businesses, many of them originating in the US. At the same time, a growing number of knock-off products have appeared in Europe, imitating popular American brands but appealing to anti-American sentiment in Europe's large Muslim population and among other Europeans opposed to American policy in Iraq. "From a business perspective," says Bilal Hallaq of Franchise Development Services, a British consulting firm, "it has catalyzed a move to more insular markets." There is no easy way to know whether the effects of anti-American sentiment on American businesses in Europe will be substantial. They may be masked somewhat by the general economic slowdown, which has already reduced investment.

The problems that anti-American sentiment in Europe may be causing for American companies already operating in Europe and the Middle East are hard to gauge. The Starbucks franchisee for Switzerland and Austria, Bon Appetit Group, sold its 21 stores back to Starbucks Coffee Co., in March, less than two years after opening them, prompting speculation in the Swiss media that concern about anti-American sentiment harming the stores' sales played a role as well.

On the right track?



The Japanese Government raised its evaluation of the economy for the first time in eight months in March 2003, saying companies were spending more on factories and machinery. "Corporate profits are improving and business investment is showing an incipient recovery," the Cabinet Office said in its monthly economic report. It described the current state of the economy as 'flat.'

Companies such as Sharp Corp., Japan's biggest liquid-crystal display maker, are investing more heavily. Business spending rose 2.6% in the fourth quarter, accounting for more than half of Japan's 0.5% expansion in that period. The monthly report gives the government's view of previously released economic statistics and rates the economy 'higher,' 'lower' or 'unchanged' from the previous month. July 2002 was the last time the government raised its economic assessment.

N Janardhan Rao

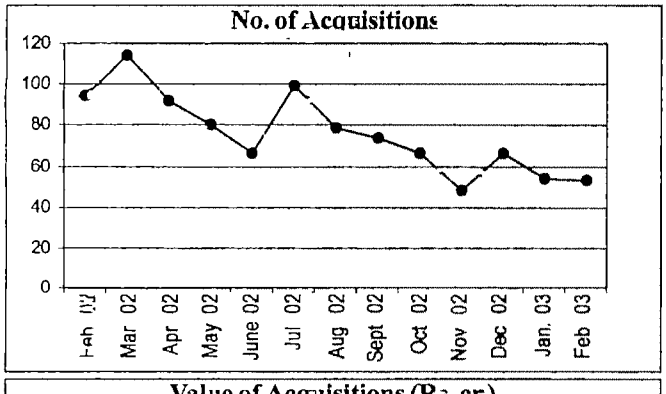
Deal Corner

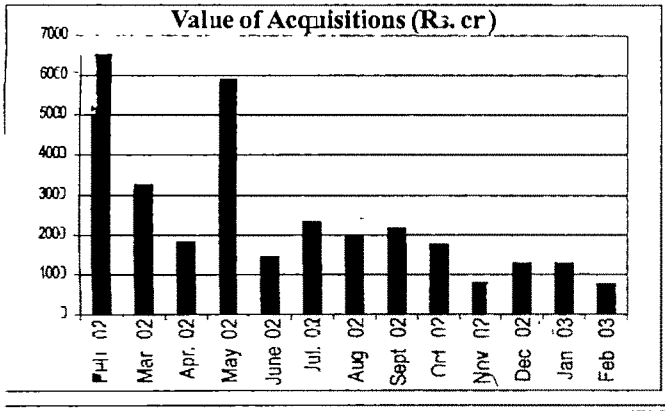
Sixty-six M&As aggregating Rs. 764 cr were recorded during February 2003. The average value per acquisition fell to Rs. 14.42 cr, the lowest in fiscal 2002-03. Mergers announced in February 2003 were also the lowest recorded during the current fiscal. The slight uptrend observed in December 2002 and January 2003 appears to be undergoing a reversal.

Trends in M&A deals

1070 M&As aggregating Rs. 21,357 cr were announced during April 2002-February 2003, compared to 1,218 deals worth Rs. 31,812 cr struck during the same period in the fiscal 2001-02. The number of acquisitions plunged to 777 compared to 934 deals recorded during April 2001-February 2002. Mergers, however, experienced a 3% rise to stand at 293. The disinvestments initiatives by the Central Government amounted to Rs. 3,265 cr, accounting for nearly one-sixth of the total.

The 2003-04 budget has attempted to reverse the downtrend in M&A activity. Banking sector and computer software industry will benefit from the budget. February 2003 was dominated by M&A activity in the IT sector. SSI finally commenced its acquisition of rival IT education and training major, Aptech. NIIT consolidated its domestic and global operations. The



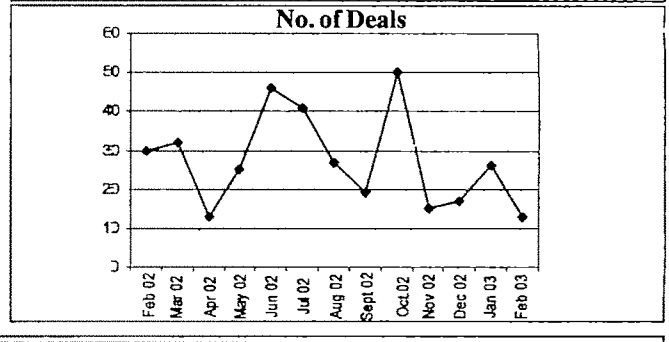


Month	Industry*	No. of Deals	Corresponding Value (in cr.)
Feb. 2002	Chemicals &	12	321
	Financial Services	12	81
Mar. 2002	Financial Services	20	599
Apr 2002	Chemicals	15	334
May 2002	Chemicals	11	2,860
June 2002	Chemicals	9	186
	Financial Services	9	369
July 2002	Electronics	20	89
Aug. 2002	Electronics	13	977
Sep 2002	Chemicals	13	279
Oct. 2002	Chemicals	14	274
	Chemicals and Plastics	14	274
Nov 2002	Electronics	11	48
Dec 2002	Financial Services	8	54
Jan. 2003	Financial Services	7	135
Feb 2003	Electronics	15	73

*Month-wise topper in terms of number of acquisitions

Month	Industry*	Value (in cr.)	Corresponding No. of Deals
Feb. 2002	Electricity	560	2
Mar 2002	Chemicals	972	19
Apr 2002	Non-ferrous Metals	475	3
May 2002	Chemicals	2,860	11
June 2002	Electricity	481	4
July 2002	Financial Services	265	10
Aug. 2002	Electronics	977	13
Sep 2002	Financial Services	1,320	4
Oct. 2002	Diversified	945	1
Nov. 2002	Chemicals and Plastics	319	7
Dec. 2002	Electricity	743	1
Jan 2003	Transport and Communication Services	367	6
Feb. 2003	Financial Sevices	182	6

*Month-wise topper in terms of value of acquisitions



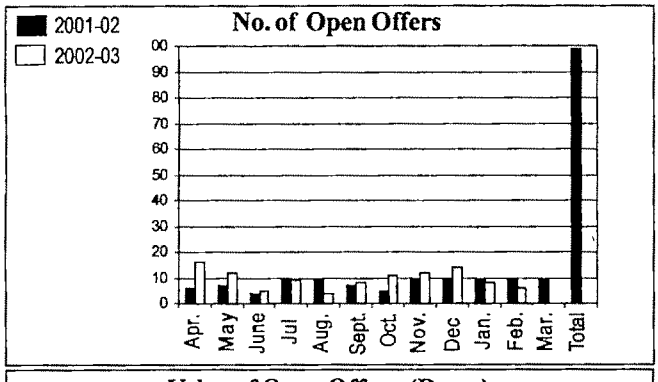
company has acquired eGurocool.com Pvt. for Rs. 1 cr. The drugs and Pharmaceutical segment also saw a fair share of M&A activity in the month.

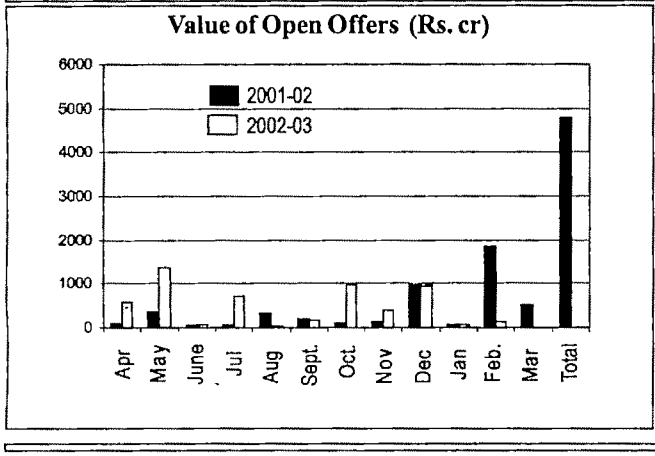
Open offers

Six open offers aggregating Rs. 130.1 cr were announced during February 2003. Barring one, which was a subsequent exit option to an open offer made earlier, the remaining five, amounted to Rs. 126.62 cr. Only one open offer was made by an MNC—US-based Caterpillar in an attempt to consolidate its holding subsequent to the delisting of a company. The number of companies targeted for delisting on completion of open offers rose to 49 during the first 11 months of fiscal year 2002-03.

No. of Open Offers

	1998-99	1999-00	2000-01	2001-02	2002-03
April	8	10	6	6	16
May	8	7	9	7	12
June	8	2	2	4	5
July	2	4	2	10	9
August	5	4	6	10	4
September	7	3	6	7	8
October	5	6	10	5	11
November	3	5	2	10	12
December	4	18	10	10	14
January	11	6	5	10	8
February	1	13	3	10	6
March	7	11	15	10	–
Total	69	89	76	99	–





Value of Open Offers (Rs. cr)

Month	1998-99	1999-00	2000-01	2001-02	2002-03
April	97.0	9.5	38.2	112 6	595 5
May	793.9	138.3	660 8	351 9	1,377.0
June	54.8	11.1	0 6	72.4	76.1
July	22 2	50.4	58 6	63 1	725 4
August	56.4	4 4	2 0	335.4	23.8
September	50.9	14 6	22 3	205.1	147.4
October	22 1	14 6	199.9	110 3	964 1
November	7 0	47.7	43 2	128.2	381.8
December	10.4	138.1	1,047.4	963.6	954.8
January	194 5	38.9	18.7	66 2	66 6
February	0.3	8.5	46 6	1,855 6	130.1
March	17 2	276.2	487.3	526 5	–
Total	1,326.7	752.3	2,625 6	4,790.8	–

Substantial acquisitions of equity stakes in companies

While rival computer education and trainir providers—SSI and Aptech joined forces, the curre leader of the segment NIIT has taken ov eGurocool.com for Rs.1 cr, excluding the liabilities the company, aggregating Rs. 9.14 cr. Then there w management buyout of Glenmark Laboratorie manufacturer of formulations and bulk drugs. Ma Saldanha, and associates will acquire 100% stake Glenmark Laboratories for Rs. 35 cr. The latter wholly-owned subsidiary of Glenma Pharmaceuticals, where, Saldanha was a directo State Bank of India consolidated its primary dealersh business—Discount and Finance House of India. increased its stake to 55.13% from 30%. At the san time SBI sold 1.2% of its stake in other prima dealership—Securities Trading Corporation of India.

Disinvestments

Central Government has finalized the mode disinvesting 34.01% of stake in Hindustan Petroleu Corp. through the strategic sale route. Other PSU including Indian Oil Corp. and ONGC have been barr from taking part in the competitive bidding process HPCL. Government has re-invited expression interest for the disinvestments of its 51% stake Fertilizers & Chemicals, Travancore. It has al initiated the disinvesment process of its 74% stake Hindustan Photo Films Mfg. Co.

Buy-backs

On February 17, 2003, BK Birla group company, EC Industries, made an open offer to buy-back 25% stake a maximum of Rs. 30 per share. The buy-back offer Abott India, scheduled to open on May 29, 2002, h finally commenced on February 21, 2003 followir clearance by SEBI. On the other hand, the buy-ba offer of Aarti drugs for 9.68% stake, which was closed February 5, 2003, was oversubscribed by 1.5 times.

A Sowdee

AOL TIME WARNER

Lord of troubles

AOL Time Warner, the media behemoth that resulted from the much-hyped merger is in news for all the wrong reasons. There just seems to be no end to the bad news coming from the company.

AOL Time Warner (ATW) is mired in troubles. To begin with the company has posted a $99 bn loss for the year 2002, which is one of the highest ever in corporate America. The exodus of executives from the company is yet another major cause of concern. The investigation into accounting issues presently underway adds to the uncertainty. There are a number of business-related problems such as America Online's poor performance, a debt pile of $27 bn, and general recession, which is eating into most of the businesses of the company

An ill-fated merger?

When America Online (AOL), the Internet icon decided to buyout Time Warner, many viewed the convergence of both the companies as a sure shot to success. But that was not to be. America Online used its heavily overvalued stock to buyout Time Warner for $103.5 bn. With the bursting of the Internet bubble the company had to take a major write-down in the lost goodwill. Many experts, now question the very logic of the merger and whether it was a strategically right move. In hindsight many analysts feel that the synergies that both the companies had expected could have been reaped even without the merger. For instance, the issue of delivering Time Warner's content to AOL subscribers could have been achieved through a joint venture rather than the very risky path of merger that both the companies had chosen. In addition, the concept of cross-selling has not really taken off, even with other Time Warner companies, leave alone AOL. The idea of providing Time Warner's content to AOL's millions of subscribers too has not really got into the implementation phase.

During the merger, AOL's market capitalization was riding very high given the irrational exuberance of Internet stocks and the company had used the opportune moment to takeover Time Warner using its stock as the currency. Today the stock, which touched $89 during late 1999 is trading at around $10 evaporating most of the shareholder wealth and also pointing out the ridiculously high valuations of Internet companies during that heady era. The share price has taken a severe beating with the tidings of losses and the executive resignations from the company.

Mega mergers come with problems of their own, including cultural differences. In this case, there was huge gap between the organizational culture of Time Warner and AOL. From the very beginning the executives from both the companies were head on and fighting over who had an upper hand. Though dubbed as the merger of equals it was AOL, which bought Time Warner, and hence executives from AOL had firmly established themselves in positions of power. This seemed sour for Time Warner people and the internal rift did great damage to the combine. The merger was followed by the burst of the Internet bubble, which sharply brought down the advertising revenues for AOL. In addition, the merger distracted the focus of AOL from all the critical factors that were responsible for its success. Meanwhile MSN had slowly crept into the place and today it poses a definite danger to the future of AOL.

'Largest ever loss'

ATW took many by surprise when it posted a net loss of $98.7 bn for the financial year 2002 as against a net loss of $4.934 bn for 2001. It is one of the biggest losses ever in corporate America's history. While business has been definitely suffering on a number of arenas most of that mega loss came from the severe write-down on the company as a result of the goodwill impairment. Due to the adoption of FAS 142, ATW had incurred a $54-bn non-cash charge to reduce the carrying value of the company's goodwill in the first quarter of 2002. In the fourth quarter ATW incurred a charge of $45.5 bn to

Performance in 2002

EBITDA	Actual 2002	Actual 2001
AOL	$1.798	$2,914
Cable	2,766	2,628
Filmed Entertainment	1,232	1,017
Networks	2,032	1,797
Music	482	419
Publishing	1,155	909
Corporate	-352	-294
Merger and restructuring costs	-335	-250
Intersegment eliminations	-56	-86
Total EBITDA	$8,722	$9,054

Source: www.aoltimewarner.com

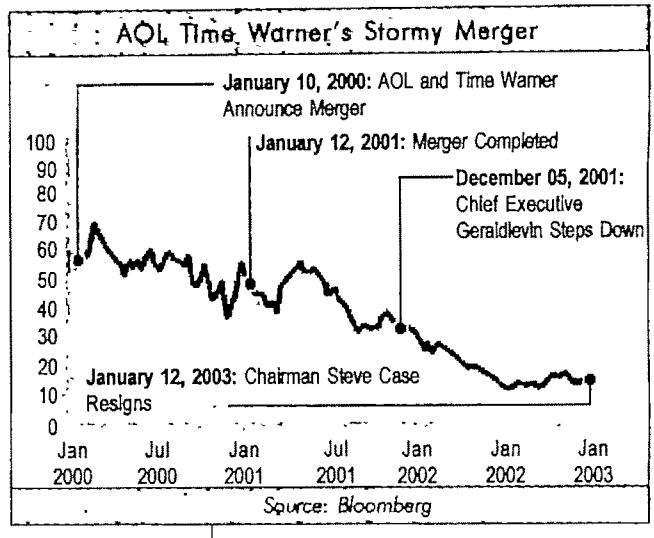
reduce the carrying value of the goodwill as well as certain other intangible assets.

The performance of many of ATW's segments has not been encouraging. AOL in particular is being seen as a poor performing division eating into the profits from other divisions. Both the topline and bottom line decreased at AOL by 4% and 22% respectively for the year. While the subscription revenues increased marginally there was a decline in advertising and content and other revenues. Subscription revenues increased by 16% but advertising and commerce revenues decreased by 39% as a result of the lower current period sales as well as the declining benefits from prior period advertising contracts. AOL subscription base has increased by two million in the US and Europe while it declined to 100,000 in other parts of the world. ATW's other businesses such as Cable, Networks, Music and Publishing have all reported positive results with growth in revenues and EBITDA during 2002. The success of Lord of Rings and Harry Porter added to the company's revenues.

The debt mountain

ATW has a huge debt of $27 bn. Richard Parsons, a Time Warner veteran, is desperate to get that figure down to $20 bn by 2004. But the task is daunting given the poor performance of various businesses and the general recession in the market. However, the task has become all the more important for ATW since this would affect its debt rating and severely restrict its ability to raise capital further. In fact, with the severe write-downs its balance sheet could soon fall below the standards set by banks and its creditors.

ATW is planning to sell its stake in certain non-core businesses in order to reduce its debt. It is also planning to put on block some of its businesses, where it does not have the scale to compete. These include its three Atlanta sports franchises, its book-publishing group and stakes in cable networks Court TV and Comedy Central. Warner publishing division is already up for sale but there has not been any special interest from prospective buyers. The proceeds could fall much below the $400 mn, which ATW expects from the sale. Harper Collins announced that it is not in the race. In addition to these sell-offs, ATW has plans of going for an Initial Public Offering (IPO) of its cable company. Some of the proceeds of the IPO too will be used in reducing the debt. AOL sold its share of satellite company Hughes Electronics in January for $800 mn, which is 50% of what the company paid to acquire it in 1999.



Executive exodus

The problems of ATW have begun to take toll. There have been some high profile departures from the top management of the company. The two main architects of the merger are no longer a part of the management. Steve Case, the founder of AOL and the person largely credited for the tremendous success of AOL has stepped down as the chairman of ATW amid severe pressure from the directors. He has been replaced by Richard Parsons. Gerald Levin, who was the CEO of Time Warner during the merger, left the organization citing personal reasons. Ted Turner, the founder of CNN and the single largest shareholder at ATW has resigned as the vice-chairman of the company. Chief Operating Officer, Robert Pittman, has also left the organization. These ranks are being filled in by more conservative managers with proven track record. Jonathan Miller has been chosen to lead AOL, Richard Parsons has taken over as the CEO and Chairman Elect of ATW. Many fear this change in executive suite could mean a change in the organizational culture at ATW. And to what extent the new culture could go well with the troubled AOL is a big question in itself.

Amidst this chaotic situation, there is another threat looming large like the Damocles sword on ATW, the ongoing investigations by the SEC on its accounting irregularities. If the investigations end up in alleged fraud, ATW could face a number of costly class action suits from shareholders besides the loss of public image. Given the present state of heightened investor sensitivity, it could prove to be an irreparable damage to the company.

Speculation is rife about the future path of AOL Time Warner. For now, the top management vows by its commitment to support the troubled business of AOL, but who knows what the future could be. But the saga of the last two years raise some interesting questions about big mergers and their accompanying 'synergies'. There is no dearth in people who feel Time Warner, for one, could have been in a much enviable position was it not for this merger.

Related Article:

1 AOL Time Warner Hype all along, *Analyst*, October 2002.

D G Prasuna

Reference # 1-2003-04-01

CHINA

The mounting challenges

A tremendous military build-up has been going on in China for the last 10 years. It could increasingly threaten its neighbors, as well as challenge US power in the Western Pacific, says E G Ross, Editor. *The Objective American*, US.

China is in the midst of a great renaissance, politically, economically, militarily, and technologically. The basic question is whether China will continue to move in the direction that it has for the past quarter-century: Toward a more open, capitalistic society. There's a complicated race going on behind the scenes. Many factions are battling. It's very complex, but the flavor of it as I see it from America is:

There's the old guard of harder-line communists in Beijing. They are alive and kicking, but they are frustrated. They control less and less of the nation. For instance, it is reported that the productive southeast coastal provinces are paying only 10% of assessed taxes to the Central Government. As the economic power of the provinces rises, the real political power also shifts to them. Fortunately, more and more Chinese politicians sense this shift and increasingly attempt to align themselves with it in order to co-opt it. For now, that should accelerate the pro-capitalist trend and further undermine communism.

However, the old guard still controls the military and the secret police. Although that power is also slipping a little, it remains formidable. The Reds could still choose to crack down on the capitalist 'threat' and stop it from morphing into full-blown democratic freedom. Or they could choose another, probably interim path: Military adventurism. That might rally patriotic fervor, including some of the capitalists. It could turn China towards a dangerous state of nationalism, much as we saw it arise in Germany.

A tremendous military build-up has been going on in China for the last 10 years—the fastest in the world. China has also expanded its aid and comfort to 'rogue' states, such as North Korea, Iraq, and the like. More worrisome, it has openly targeted the US as a main enemy—even as it seeks to expand trade with America. Given these developments, there is reason to fear that China could increasingly threaten its neighbors, including India, Japan, South Korea, and the Philippines, as well as challenging US power in the Western Pacific. It will certainly make a bid to challenge India's rising blue waterpower in the Indian Ocean.

Thus, it looks like a race against time. If China's pro-capitalist factions can keep the communists from military adventurism, then a huge middle-class will continue to build in China. This middle-class will grow in power and eventually demand civil rights. Those demands will further erode the communist state and push it toward a more democratic system, perhaps resembling India's. But the communists are not stupid. They can see this trend coming. They may seek to stop it by cracking down on civil rights as happened during and after the Tiananmen Square incident.

My hope is that the West, India, and the capitalist Far East nations keep their defenses strong. This will help deter Chinese expansionism. In turn, the deterrence should encourage the continued expansion of capitalist enterprise in China. That will be good for the whole world. As a rule, capitalist nations are more peaceful nations—unless they or their allies are directly threatened. If China's capitalism continues to evolve, the United States, India, and other nations should benefit from it because all nations gain from the expansion of human freedom. China is providing—and will continue to provide—a greater division of labor to the world. This will make the planetary economy more efficient at producing a wide range of goods and services.

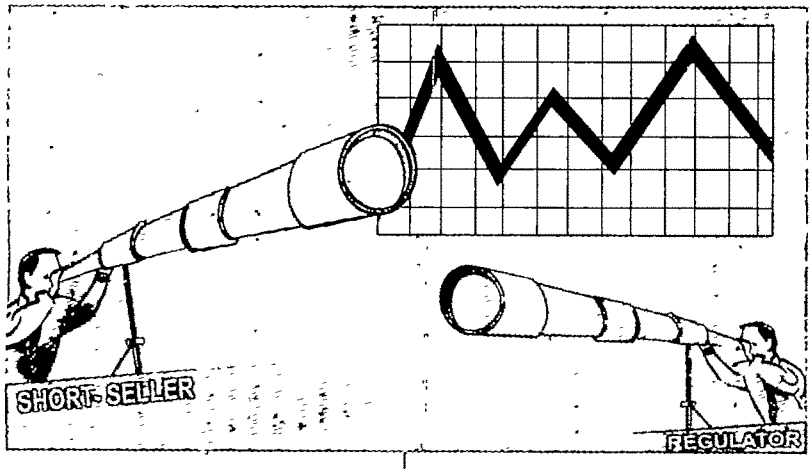
As to whether China's spectacular growth can continue indefinitely, probably not. Even in the best of systems, malinvestment builds up, like rust in pipes. Sooner or later, this leads to corrections and the need for economic and political adjustment. So far, China has avoided recession. In this respect it is following the development patterns of post-World War II Japan and South Korea. But by the constraints of human nature, spectacular growth will not continue uninterrupted. At some point, China will slip into a serious downturn. When that happens, it could also produce the greatest political turmoil we've seen since the 1970s. When it comes; it will be a test of China's maturity. If it survives the recession and moves toward greater capitalism and democracy, it will be good for everyone. If it responds with oppression or military adventurism, then it will obviously be a different and sadder story. Which way will it go? Impossible to say, for it is ultimately up to the Chinese themselves.

Reference # 1-2003-04-02

SHORT-SELLING

Under fire

As stock markets continue to be in a flux, critics look keen to put the blame on some one, and the scapegoat is short-selling. But the question is—will the market be better off without them?



Short-sellers challenge not the system, but those who abuse the system.

– A short-seller

Ironically, it is the short-sellers (bears) who are now being accused of abusing the system. In the past two years, dozens of private lawsuits have been filed accusing short-sellers of price manipulations, aimed at benefitting their clients. This sounds surprising in the wake of the fact that it was actually the short-sellers who were the first to send warning signals on some of the biggest corporate collapses like Enron and Tyco in America. Over the years, they have increasingly played a significant role by breathing in the much needed liquidity in the market and doing a balancing act by bringing sanity back to the markets when stock prices inflated artificially. Nonetheless, the current sluggishness in the markets has led investors baying for their blood. As a consequence, short-sellers, including the hedge funds, which thrive primarily on short-selling, face a tough future, as the US securities regulators prepare to launch attack on them by introducing tougher regulations. However, whether this would have a positive impact on the markets, which have been reeling under selling pressure for the last few years now, is doubtful.

Short – The soft target?

As stock prices have kept subsiding for the last couple of years, markets are keen to blame someone. And, the scapegoat is short-selling—the act of selling a security that the seller does not own, in the hope that price of the stock, which he wants to sell, would fall in future. If the stock falls in value as expected, the seller buys those stocks at lower prices and earns profits and vice versa. But the question is was it short-selling which was responsible for crash in once flying technology, Internet, telecom, and energy stocks. Wasn't the crash in Enron, WorldCom, and Tyco's shares a result of change in companies' fundamentals for worse? In fact, they were the whistle blowers who tried to alert the markets much before many yesteryear stars turned out to be dogs. "While some of this information came to light only after the company's collapse, Enron was no stranger to professional short sellers. Indeed, James Chanos was on the road making Powerpoint presentations about Enron's future demise for months before the company's trousers hit the floor in public," observes C A Green, a 15-year Wall Street veteran, and Investment Director of The Oxford Club, in one of his write-ups posted on dailyreckoning.com's website.

Given this fact, what is then the justification for cornering them out by market regulators and critics alike? Andrew Teufel, Director of Research, Fisher Investments, Inc., USA says, "During any prolonged bear market people want to find something to blame their misery on. Holding an instrument of free markets responsible for perpetuating a downward trend isn't rational."

He opines that people are afraid of the markets right now, and fear comes from lack of control. So they try to control their surroundings to prevent those same fears from happening in the future by increasing regulations. "We certainly didn't see calls for restrictions on the abuse of long positions in 1999 when the market was shooting upward and everyone was optimistic," observes he.

Pro-short-sellers say that short-selling performs a great task as a provider of much needed liquidity to the market. "Short-selling is used to give the market greater flexibility and liquidity than would otherwise have been the case. In addition, it enables risk management activities such as hedging, arbitrage, and the creation of derivatives. Disrupting

the ability to do these activities would have far-reaching negative effects to free markets," argues Teufel. Perhaps, a lesson or two could be taken from history which witnessed these so-called bear onslaught on many occasions and attempts by regulators to ban short-selling only to see them faltering later

Backlash for bears

The history of stock market is replete with stories of bear bashing in the wake of several crashes since the markets came into existence some four centuries ago The celebrated author of the book *The Devil Take the Hindmost,* Edward Chancellor who wrote several pieces on markets cites in one of his essays how the efforts of market regulators to curb short-selling fell by wayside every time there was an attempt to do so In 1609, a Flemish-born merchant, named Isaac Le Maire, organized a bear raid on the stock of the Dutch East India Company, based on the insider information received from the company's treasurer. Although Le Maire's raid ended in personal failure it caused the East India Company to complain to the government and seek protection from short sellers, whose attacks, it claimed, were causing harm to 'innocent' stockholders. This was the first case where the protection of the innocent was evoked in order to turn sentiment against the bears.

During the bubble periods it is the bears who are generally the lone voice of reason, warning people of the folly of investing in overpriced markets

Although the Amsterdam bourse maintained that the decline in the East India stock was due to poor business conditions—not short-selling, in 1610 the government outlawed all short sales. However, this edict was a dead letter from the start. The Dutch banned short-selling again in 1621 but to no effect.

As the stock markets were established in Britain and France in the 18th century, further legislative traps were laid to confine the bears. Following the collapse of the Mississippi bubble in 1720, bears, who had profited from the decline in the Mississippi stock, were fined and a law was introduced outlawing short sales. At around the same time, the English had witnessed the startling rise and collapse of the South Sea Company, which had risen from around £100 to nearly £1,000 in the first six months of 1720, only to fall back to where it started in the autumn of the same year.

Some 13 years later, a Bill was brought before the British Parliament by one of its members, Sir John Barnard. The Bill's aim was to prevent the wicked, pernicious, and destructive practice of stock jobbing (or speculation). Sir John Barnard's Act, as it was called, outlawed the use of futures, options, and short sales of stock. It remained on the statute book until 1860. From its beginning, however, few paid attention to the letter of the law: Brokers continued to engage in short sales which were enforced through a code of conduct rather than legal sanction.

These two early pieces of legislation against short-selling, says Chancellor, "reveal a common theme in the history of the bears." Bubbles occur when speculators drive asset prices far above their intrinsic value. The collapse of a bubble is frequently accompanied by an economic crisis. Who gets the blame for this crisis? Not the bulls, who were responsible for the bubble and the various frauds and manipulations perpetrated to keep shares high, while they cash in their profits. "No, it is invariably the bears who are blamed for the post-bubble crises and are the main objects of anti-speculative legislation," remarks Chancellor. Yet during the bubble periods it is the bears who are generally the lone voice of reason, warning people of the folly of investing in overpriced markets. "In the aftermath of a bubble, they continue their forensic work of exposing unsound securities and bringing prices back in line with intrinsic values, a point that must be reached before recovery can start," adds he.

> **"Placing restrictions on free markets is nearly always a bad thing. Short-selling provides a very important market function—liquidity in the market. If you eliminate it, you'd probably get more volatile markets...not less."**
>
> **Andrew Teufel**
> *Director of Research*
> *Fisher Investments, Inc., USA*

Ever since the trauma induced by the collapse of the Mississippi bubble, the French have retained a more pronounced aversion to financial speculation than the English. Napoleon disliked bears and believed that short-selling was unpatriotic. In 1802, he signed an edict subjecting short-sellers up to one year in jail. The French prejudice against the so-called Anglo-Saxon capitalism continues till today. After George Soros and other speculators drove sterling from the Exchange Rate Mechanism in September 1992, the French Finance Minister, Michel Sapin, commented that 'during the Revolution such people were known as *agioteurs*, and they were beheaded. Surprisingly, despite market's criticism of short sellers during the 1929 crash of the US markets, there is little evidence of organized bear raiding on the US markets.

Chancellor says that hedge funds, of course, have become synonymous with bear raiding.

The first complaint about their short-selling activity surfaced in May 1970 when a broker petitioned the SEC to ban short-selling and make hedge funds illegal. In the 1990s, there were numerous complaints against hedge funds, relating in particular to the Asian crisis of 1997-98.

In 1997, President Mahathir of Malaysia claimed a 'Jewish conspiracy', led by George Soros, who was trying to re-colonize the country. He banned the short-selling of companies in the Kuala Lumpur index. In the following year, the Hong Kong authorities started buying large chunks of their own stock market in order to fend off an alleged bear raid by hedge funds. Yet academic research shows that hedge funds were not responsible for precipitating the Asian crisis. "On the contrary, macro hedge funds were one of the few sources of demand for Asian currencies in the autumn of 1997, when the crisis started," observes Chancellor.

Convertibles – Fueling short-selling

For those who defend short-selling, however, the recent revelations about abuse of convertible securities come as a major blow. The Securities and Exchange Commission (SEC) of the US has initiated a probe into suspicious short-selling trading activities to include market makers and broker dealers who may have been involved in the so-called 'death-spiral' financing schemes. The action of the market regulator follows a $1 mn settlement announced against Rhino Advisors, an unregistered investment adviser in New York recently. Rhino and its president were accused of being engaged in manipulative short sales in Sedona's stock in support of a convertible financing deal meant to benefit an offshore client. The pressure has been mounting over the regulator after a sharp drubbing in stock prices in recent times.

The Commission alleged that Rhino manipulated Sedona's stock price to enhance a client's economic interests in a $3 mn convertible debenture that Sedona issued to Rhino's client. The purchase agreement for the debenture expressly prohibited Rhino's client from selling short shares of Sedona's stock while the debenture remained 'issued and outstanding'. According to the Commission, despite this contractual provision, Rhino engaged in extensive short-selling on behalf of its client prior to exercising the conversion rights under the debenture and this short-selling depressed Sedona's stock price.

In the wake of the Sedona case, the focus has shifted to certain convertible securities, particularly those referred to as 'toxic' or 'death spiral' convertibles. Market experts say that these securities present the temptation for those holding the convertible securities to engage in manipulative short-selling of the issuer's stock in order to receive more shares at the time of conversion.

It would not be surprising if more and more such cases come to light in future, given the fact that many US companies used (or abused) this financing route to raise cheap money from the market. *The Economist*, UK's renowned newsweekly, commented in its edition dated November 14, 2000, that one explanation for the wretched share performance of many American companies is the wretched condition of their industries. But the pain of a tough economy was compounded, in some cases, by a bull-market bias in their balance sheets. "Many large companies are facing agony after making use of a special form of convertible bond known as 'quasi-commercial paper', it added. According to the weekly, in late 2000 and during 2001 the commercial-paper market became increasingly restrictive after some well-publicized blow-ups, including Finova, a finance company, and Xerox. That forced many companies out of the short-term debt market and into the more expensive long-term market. At the same time, share prices had become more volatile. "It was not long before creative financiers on Wall Street came up with an idea that magically seemed to restore their clients' access to low-cost debt," remarked the weekly. The outstanding for such bonds rose to touch a huge $32 bn in 2001 from $10 bn at the end of 2000 to $32 bn in 2001, according to the US investment-banking firm, Morgan Stanley. Today, with the stock markets in shambles, the danger is that the rider of put option could prove to be a nasty sting in the tail of many issuers; several disgraced firms like Tyco, Adelphia etc., which issued $5 bn in face value of convertible bonds, maturing in 2020.

In the absence of any concrete evidence, banning short-selling would among other things mean devoiding the market of the much needed liquidity

End of the road?

Under pressure from investors and critics, SEC could attempt to ban short-selling. But would that solution be warranted? Perhaps not, at least in the best interest of the market. As history suggests, the market regulators across the globe have failed to establish any concrete evidence of bears' hand in stock market crashes, including the great market crash of 1929, and the more recent ones. And back in India, it has not been firmly established that the alleged bear cartel was behind the ill-famed market crash of March 2001. Rather, a major bull-operator has been pinpointed for

manipulating prices upwards, and revelation of the same led to the crash in major indices. It would be difficult to say that bears operate in cartel, even history does not provide any evidence. Then it would be worthwhile to ask, whether the market crash is really led by bear cartels.

Given the rather miniscule size of bears, according to statistical data in US, short-selling averages around $4.2 bn which is poor when compared to the overall market size of $36.6 tn.

Given that, in the absence of any concrete evidence and bowing to any popular demand, banning short-selling would among other things mean devoiding the market of the much needed liquidity, which is the breath and soul of the market. It stabilizes prices by providing liquidity and creating demand in a falling market.

In defense of short-selling

In fact there is remarkably little evidence of organized bear raiding on the US market following the October 1929 Crash Edward Meeker, the economist of the New York Stock Exchange, and the author of the book *Short-Selling* observed that bears had not precipitated in the crash. In November 1929, the NYSE found that around one-hundredth of one percent of outstanding shares had been sold short.

A later study in May 1931 found that the short-selling interest had risen to three-fifths of one percent of the total market value which was more than 10 times as many shares were held on margin. Nor could the stock exchange identify any bear raids in the subsequent market decline. A study of large block sales identified the liquidation of long positions as the main cause of weakness. Forced sales by margin-traders also contributed to the decline. Meeker provided an eloquent defense of short sales. He refuted the conventional charges against short-selling—namely that it is illegitimate to sell what one doesn't own, that short-selling creates a fictitious supply which is responsible for declining prices, that it leads to greater price fluctuations, practiced only by insiders as a fraud on the general public, it is simply gambling, a technique to manipulate prices and it constitutes an attack on the property of shareholders.

Instead, he argued that the bears stabilize prices by providing liquidity and creating demand—by covering their short-selling—in a falling market. Short-selling was not illegitimate, in his view. "A short sale", wrote Meeker, "represents a debt contracted in goods rather than money". In this it was similar to many other business contracts. He argued ingenuously that margin trades and short sale were simply the inverse of each other: The margin trader borrowed cash to buy stock, the short seller borrowed stock in order to raise cash.

A more appropriate approach to overcome the problem of irrational exuberance over short-selling would be to raise the awareness level of investors

The margin trader closed his position by repaying the cash loan through the sale of the stock the short seller closed his position by purchasing the stock and returning it to the lender. It was no less legitimate to borrow a stock in anticipation of decline, than to borrow money and purchase in anticipation of a rise. Meeker denied that short-selling was damaging to shareholders, since the "only property which could be diminished by short-selling is an inflated valuation to which the security holder is nowise entitled." He strongly distinguished between short-selling and manipulation, and argued persuasively that a market without short sellers would be more open to manipulation.

"Short-selling," argued Meeker, "is really an expression of opinion, subject to personal risk, as to the value of securities' short-selling has no effect upon the assets or earning power of operating companies, even in the case of banks. It cannot determine value, but only estimate what prospective values really are and will be." Contrary to popular myth, says Chancellor, short-selling doesn't affect fundamental values, except during the relatively rare periods when a company is raising money through a secondary or rights issue. We need more, not less, short-selling activity if, in future, we are to avoid wasteful bubbles, such as the recent technology, media and telecoms boom.

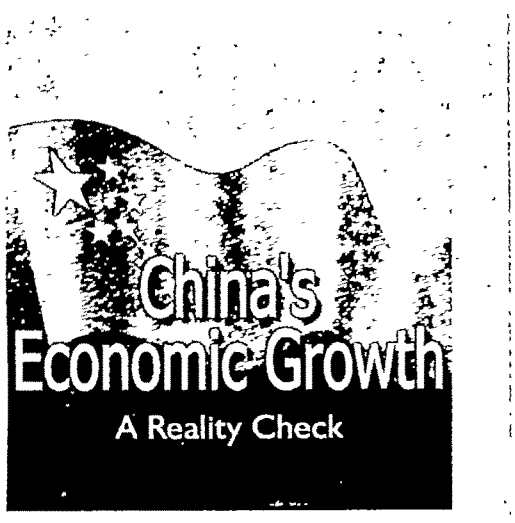
Let the market decide

Given that, it would be desirable that market regulators devise a mechanism to monitor and facilitate trading rather than choking it. As Teufel observes, "if you eliminate (short-selling) it, you'd probably get more volatile markets... not less."

Perhaps a more appropriate approach to overcome the problem of irrational exuberance over short-selling would be to raise the awareness level of investors. "Short-selling is not for everyone. It takes time, practice and plenty of due diligence. And, since there is no limit to how high a stock can go (at least theoretically), it takes a disciplined approach that allows an investor to cut losses early and let his or her profits run," advises Green. On top of all, probably one would say, let the collective wisdom of market alone prevail.

Amit Singh Sisodiya

Reference # 1-2003-04-03



China's Economic Growth: A Reality Check

It is the new 'workshop' of the world. Undoubtedly, the dragon has successfully conquered the global manufacturing turf by churning out low-cost, quality goods, catering to consumers across the globe. China's growing influence in manufacturing is being seen as a threat by many experts and nations. According to critics, however, there is more myth than reality about China's miraculous growth story. The cover story takes a close look at China's claim of its stupendous growth and attempts to reveal the reality behind.

The business world in the 19th century was convinced that Britain was the original workshop of the world; later similar thoughts went about in the US in early 1960s, in Japan during the 1970s and South Korea during the 1980s and 1990s. Now the focus has shifted towards China—the new industrial monster. In hindsight, Britain took almost a century to multiply its per capita income two and half time. The US per capita increased three and half times in 60 years from 1870 to 1930, which is six times that of Japan from 1950 to 1975. However, China is the fastest of all. Since its reform process in 1979, China's income has risen sevenfold. Chinese economy was once largely based on agriculture, but now the focus is more on sophisticated products such as electronics and other light manufacturing goods.

In dollar terms, China is the sixth largest economic entity, with an annual gross domestic product at more than 7%, and a total of over $1 tn. It is also the sixth largest exporter; its annual direct foreign investment remains at above $40 bn and foreign exchange reserves at $225 bn. These figures show that China has become a new pillar of the world economy. In terms of purchasing power parity (after adjusting for price differences between economies) it is second only to the US with an 11.8% share of world GDP. Its growth rate too is extraordinary. The economic growth in 2001 and 2002, at 7.5% and 8% respectively, was particularly eye-catching given the global economic slowdown.

Multinationals have been relocating their low value-added production processes to developing countries in pursuit of lower cost. Against this backdrop, China has been taking advantage of its cheap and abundant labor to attract direct investment by multinationals, thereby accelerating the pace of industrial development.

China already is the largest consumer market for refrigerators, washing machines, color TV sets and mobile telecom services. It is not only the engine of market demand, but also the largest low-cost labor market, with per-hour cost standing at only $4.88, equivalent to 18% of Japan's, 23% of the US, and 56% of India's. It has an immense ability to produce manufacturing goods with low wages within a labor force, which has good amount of human capital. Its competitiveness in international markets is mainly based on the abundant supply of cheap labor, broadly in line with its level of economic development. The diverse produce by China range from textiles, where it is already the world's leading producer, to light manufactured goods and now high-tech products. Dr. Linda Yueh, economist, London School of Economics, UK, an expert on Chinese economy says, "Its product mix is impressive; the government has succeeded in developing its bases for comparative advantage including direct industrial policy in areas such as Pudong in Shanghai, and its ability to attract Foreign Direct Investment (FDI) is formidable. China has become the top one or two preferred destination for FDI without adopting financial liberalization of capital accounts or full currency convertibility. Foreign capital into Foreign Invested Enterprises (FIE) has contributed more than 50% of industrial output in recent years. These factors of the labor force, governmental policy, and economic/political stability that attract FDI combine to make China an impressive manufacturing hub." In short, it is becoming a global manufacturing hub. A report on the global investment situation in 2001, initiated by the United Nations Conference on Trade and Development (UNCTD), shows that at present nearly 400 of the *Fortune* 500 enterprises have invested in more than 2,000 projects in China.

China has been one of the key dynamos in Asia's economic development since its reforms. It was able to weather the storm of the 'Asian crisis' relatively unscathed, and has sustained rapid growth in the face of current global downturn. Increasingly, China is looked upon as the next economic power in Asia, especially when compared to the troubled Japan. Shanghai is regaining its stature as an Asian financial center. As the world's major economies are witnessing prolonged recession, it's the only bright spot in the world economy. Some are wondering whether the People's Republic of China (PRC) can become the new engine for world growth. If we consider the present global economic conditions, certainly the prospects for Chinese economy are rosy because no other major economy will report anything near 7-8% of growth for 2002. The Chinese boast that the 21st century would be the Chinese Century, when China will become the superpower first in Asia and then of the world. Concurring the same view, Lehman Brothers, the investment bank based in the US opines that "...China can sustain an average annual economic growth rate of 6% and dislodge Japan as the world's second largest economy in less than three decades..." If this growth is sustained, says Lehman, "...China's economy by 2030 will be bigger than each of the major European economies and could conceivably displace Japan to become the largest economy in Asia, and the world's second largest economy after the US...."

If we consider the present global economic conditions, certainly the prospects for Chinese economy are rosy

> **"The problem arises because the domestic incentive structure is set up in a way that it rewards output growth without any regard for profitability."**
>
> **Devi Aurora**
> *Associate Director*
> *Global Fixed Income Research*
> *Standard & Poor's*
> *US*

A rising economic superpower?

Despite all the sunny predictions for the world's most populous nation, today the debate is whether the pace of the country's development is sustainable or not. Chi Hung Kwan, Senior Fellow, Research Institute of Economy, Trade and Industry (RIETI), Japan says, "Economic strength depends on the size of the Chinese economy, not its rate of growth. Although China has been growing at an annual rate of almost 10% over the last 20 years, its GDP is still only a quarter that of Japan." For all its rapid growth, China's share of world trade is simply around 4%. However, Chu-yuan Cheng, a Business Professor specializing in the economic trends of Pacific Rim nations opines "China is on the brink of becoming a major economic power. Economic reforms and open-door programs have provided a powerful

impetus for development." Going by this trend, American corporations have rushed into China seeking to win over its population of 1.3 billion and a middle-class expected to grow to 500 million by 2010. McDonald's has 400 restaurants in the country and plans to add 100 outlets annually. Major corporations such as General Motors, Dupont, Intel, Motorola, Wal-Mart, Eastman Kodak and KFC have made major investments in China. "With its membership in the World Trade Organization, fields such as telecommunications, banking and insurance are now open for foreign investment," says Cheng. US multinational companies have an edge in these areas. "China has enjoyed an unprecedented period of rapid growth and will keep the momentum in the years to come," says he.

As China moves toward modern industrialization and globalization, Cheng believes that there are also unavoidable social and economic effects. These include widespread corruption, widening income gap between rich and poor, and rising unemployment as the government tries to increase efficiency of state-owned enterprises by shedding employees who are not needed in the system. However, he observes, as long as the Chinese economy continues to expand, many of these problems may gradually fade away. The Chinese economy may then form a circle of growth when economic success causes further reform and impedes any attempt to return to the old system.

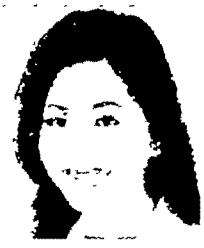
Coming to the issue of super economic power, the difference (against the US), of course, is that China is now a major trading power and a serious, low-cost competitor in the global economy. Even so, with all the Chinese made toys and textiles while the US retains its technological lead, China would hardly rank as an economic superpower. Because of its huge population, nearly five times that of the US, China does not have to be a rich country to have the world's largest economy.

World's manufacturing hub

Issues like abundant supply of low-wage labor, efficient export-oriented infrastructure, a vibrant private/export sector that receives a high volume of foreign investment and absence of exchange-rate volatility are making China as the global manufacturing hub. According to an international economics guru, Robert Mundell, Professor of Economics, Columbia University, New York and Nobel Laureate, China will become the 'factory of the world' and he expects that in 20 years time, most automobiles in the world will be produced in China, and most South-East Asian countries will "try to forge some sort of free trade area" with China. Recently, *Fortune* indicated that China is going to be a workshop of the world with a large number of high-quality technical personnel and huge markets. It analyzed that 10 years ago China exported mainly toys, textiles and other cheap products, but now it has become a reliable and stable producer of high-value and high-technologically sophisticated products.

China is now the main outsourced manufacturing platform, and in many places, such as Britain and the US the effect has brought down the prices of goods

Today, there are few things in the global marketplace that aren't made in China. Many foreign manufacturers feel that they must either produce in China or expand their purchases from China. The country has become the world's factory floor, with an output so massive and wide-ranging that it exerts deflationary pressure around the globe on everything from textiles to TVs, mobile phones to mushrooms. It is now the main outsourced manufacturing platform, and in many places, such as Britain and America the effect has brought down the prices of goods.



"China is facing structural problems, which will pose significant challenges to its future, but its past success should be acknowledged."

Dr. Linda Yueh
Economist
London School of Economics, UK

Exports of manufactured goods have increased sharply in recent years to account for 90% of China's overall exports in 2001. China has been the world's second-largest recipient of foreign direct investment, taking the lion's share of all the investment flowing to developing countries. It is the world's fourth-largest industrial base, in terms of value of goods produced, after the US, Japan and Germany. These days, China makes more than 50% of the cameras sold worldwide, 30% of the air-conditioners and televisions, 25% of the washing machines, and nearly 20% of the refrigerators. A private Chinese company, Guangdong Galanz Enterprise Group Co., now accounts for 40% of all microwave ovens sold in Europe. The city of Wenzhou, in eastern China, sells 70% of the world's metal cigarette lighters. Processing trade, which represents

"Reform is making the problems worse, and China could face a financial crisis in the next half decade."

— *Gordon G Chang, Author,* Coming Collapse of China

O On global manufacturing hub and implications.

China today offers cheap labor everywhere and, in many localities, minimal environmental restrictions. In the coastal portions of the country there is a critical mass of industry and transportation which is generally good. Chinese manufacturers are driving down the cost of low-end goods around the world. Factories are moving to China, thereby contributing to unemployment around the globe.

O On China's unprecedented economic growth – as a threat and opportunity.

China is both a threat and an opportunity. China is a threat to low-end manufacturing. It also presents an opportunity for suppliers of materials and raw products as well as manufacturers of machinery and high-tech products. The Chinese are forcing other Asian countries to move up the value chain as fast as they can.

O On sustainability of present growth.

Present growth is unsustainable. Growth these days is essentially dependent on three factors: Fiscal stimulus, foreign direct investment, and exports. Chinese record budget deficits, just like the one that was announced in Beijing last week, mean that government pump-priming must end soon. The economy is now hooked on ever-increasing infusions of Central Government cash, and that flow of funds is not sustainable in the long run. The deterioration of Central Government finances in the last five years is alarming.

The world is already plagued with too many factories, both in China and elsewhere. At some point excessive capacity will mean that inward investment must slow. The world doesn't need too many factories, even in countries as attractive as China. We are rapidly approaching global saturation. As the world economy continues to slow, export growth will end. Chinese factories can produce, but the world is running out of consumers

O On China's manufacturing sector ability to compete with other countries.

China's ailing state sector has shed workers by the tens of millions in the last decade. That threatens social stability. Massive non-performing loans threaten the state banks, which are hopelessly insolvent. Reform is making the problems worse, and China could face a financial crisis in the next half decade.

O As a threat to American predominance.

The American economy has been in transition for decades, moving away from low-end manufacturing and towards the provision of services. China, of course, is a threat to the remaining low-end manufacturers When China fully opens its economy to goods and services, as it has promised in order to join the World Trade Organization, the Chinese economy will benefit America.

O On India – the next super economic power.

India is the next big country to flourish. India started reform later, so it is behind the curve as compared to China. As long as the Chinese economy continues to grow, India will be forced to reform to keep up. The risk for India is that it will backslide once the Chinese economy goes into reverse—then, the pressure will be off.

roughly half the overall trade of China, has come to play a more important role in the Chinese economy. With its share of the world's manufactured exports rising, China has been widely recognized as the world's manufacturing hub.

However, Kwan opines that "so long as China depends on low wage levels to compete in international markets, it can at best be a 'factory of the world' rather than an 'industrial power' that would rule over such high value-added areas as product standards, brand names, and core technologies." Since low wages also imply a low standard of living, no doubt they should be understood as a sign of China's weakness. Though the flood of cheap Chinese imports have resulted in job losses for US workers who compete against Chinese manufacturers, it has been a boon for American consumers. However, Andy Xie, an Economist, Morgan Stanley, Hong Kong, warns "it is going to have the same kind of impact on the world that the industrialization of the US had, perhaps even bigger." Since May 2002, America's monthly imports from China have consistently outstripped those from Japan. After decades of exporting mostly low-end products, such as textiles and toys, China has moved into more sophisticated goods, such as computers and DVD players and other electronic goods. These exports affected most industries in US.

However, the large gap in productivity between China and the developed countries means that, when China participates in the global markets, it can do so only by specializing in labor-intensive products (or labor-intensive processes for technology-intensive products) in accordance with its comparative advantage based on low wages. Going by this, China's exports will be dominated by labor-intensive, rather than technology-intensive products. For instance, China's total R&D investment in the year 2000 was $10.7 bn, or approximately the amount of the annual R&D investment by the German manufacturing giant Siemens, which stands at about $10 bn. Kwan opines that "Since China has an enormous surplus of labor in its rural areas, further increase in the demand for labor in manufacturing areas would not result in upward pressure on wage levels. Thus, for the time being, China should have no problem sustaining its competitiveness in labor-intensive products. In these circumstances, however, since for Chinese corporations the optimal strategy is to expand labor input rather than improve productivity, low wages could actually be a factor retarding the advancement of industries."

China should have no problem sustaining its competitiveness in labor-intensive products

Robust growth – Threat or opportunity?

China's unprecedented economic growth can be intimidating. Many Asian nations fear that their economies will suffer as Chinese workers churn out ever-greater quantities of inexpensive exports of ever increasing quality. The flood of exports is being matched by unprecedented inflows of foreign direct investment into China. Contrary to the view that China's exports will stifle competitiveness and growth among its neighbors, the expansion of the Chinese economy—particularly when accelerated by WTO conformity—will bring unprecedented market opportunities to exporters in other East Asian countries. China seems set to be East Asia's largest trading nation by 2010. Its growth will dramatically change the regional economy. China is not only the largest industrial economy among developing countries, but also the fastest growing.

"Whether or not China's growth is seen as a threat depends on one's perspective, says Devi Aurora, Associate Director, Global Fixed Income Research, Standard & Poor's, US. He further adds, "Global consumers worldwide benefit from easy availability of high-quality goods at low cost. However, other low-wage developing countries with export-oriented goals are likely to view China's export juggernaut as a threat to their own development, unless they are able to find a niche in selling products that are useful for China's domestic market, or are able to compete on the basis of an even more compelling wage/productivity combination. At the same time, however, countries that are producers of higher value-added, capital-intensive goods are likely to benefit from the prospect of being able to sell into the growing domestic market in China."

Experts say China's rise and integration into the global economy through the WTO can be very positive for other Asian countries if they do not isolate themselves from the process. The same view is also echoed by Dr. Linda. She says, "Trade with a country that experiences such efficient productive advantages will improve the efficiency of its trading

"So long as China depends on low wage levels to compete in international markets, it can at best be a 'factory of the world' rather than an 'industrial power'.

Chi Hung Kwan
Senior Fellow
Research Institute of Economy Trade and Industry (RIETI)
Japan

partners. All countries will benefi to differing degrees, but some wil suffer erosion of market share an weakened industrial performance Moreover, when China engages i trade with more develope countries, its requirements for FD include technology transfe provisions. When China trade with LDCs, there can b dissemination of know-how, whic will improve the growth prospect of each trading partner. Growt will depend on improvin productivity. The impetus provide by China's example and the lesson gained from its success will benefi the development strategy of othe countries. In fact, China i repeatedly cited as a country which has managed growth on it own terms, without depending o Western advice. This is a important view to keep in mind a its success holds lessons for othe countries."

Contradicting the above view Susmita Dasgupta, Deput Economist, Joint Plant Committe (Steel) opines, "China's growth wil be a threat to the developin countries like India. This i because India is competing wit China in matters of production o

finished goods for the same world market like software. In the product market, China's growth will be a threat to all those who have the same line of goods to produce, especially the low prices of Chinese goods push down the prices of most commodities. In the financial market, however, China's growth will be a boost to the global economy because it assures capital to its circulation." However, more and more people in Japan have come to perceive the rise of China as a threat, prompted by the sharp contrast between the growth performance of the two countries in recent years. It should be noted that the economic relations between Japan and China can be characterized as complementary rather than competitive, reflecting the prevailing gap in the level of development.

Kwan opines, "Both sides can benefit by promoting a division of labor according to comparative advantage, with China specializing in labor-intensive products and Japan specializing in high-tech products. To this end, Japan needs to facilitate the relocation of declining industries to China, while at the same time proceed boldly with its structural reform." Echoing similar views, Chinese Economist Lin Yifu says, "The continued economic growth in China in the coming decades will create enormous opportunities for other countries, especially for Asian countries, instead of threat, as China will provide a still broader market for them and create conditions for them to upgrade their industrial structures, Jim Walker, Chief Economist, CLSA Emerging Markets says "In addition to niche opportunities in other countries, increasing demand for all kinds of goods by China's growing middle-class will open up," he further adds.

China's accession to the WTO will imply that it will begin to move toward greater marketization. As China removes more of the impediments as a result of its accession, China's influence on the global economy will grow. WTO accession provides the access to foreign markets previously denied to China as it was not a part of GATT. It has also begun the process of opening China's domestic markets and encouraged the adoption of laws and regulatory rules to govern private economic relationships. These factors will inevitably raise China's share of global markets. The increased penetration of foreign markets, especially in agriculture, will undoubtedly increase the size of China's economy. The myth is that China will begin to produce all of the world's goods. The reality is that under the theory of comparative advantage, even if China experiences absolute advantage in production in all areas of manufacturing, agriculture etc., it will still begin to specialize. Therefore, trade will benefit all nations, improving their efficiency and that of the global economy.

Unit Labor Cost by Country Comparison with US

	Wages (A)	Labor Productivity (B)	Unit Labor cost (A/B x 100)
US	100.0	100.0	100.0
Japan	62.6	67.8	92.3
Singapore	49.0	49.0	100.0
Taiwan	43.1	24.4	176.9
Korea	27.0	43.9	61.5
Malaysia	10.9	12.9	84.9
India	3.1	2.9	107.7
China	2.1	2.7	76.9

Source: UNCTAD Trade and Development Report 2002

A sustainable growth?

The present conditions in China is really quite contrary to popular perceptions. Gordon G Chang, the author of the book *Coming Collapse of China* says that China is a weak giant, not a strong one. Its growth has not been trouble-free. The country still faces huge problems: How to deal with its moribund state enterprise sector without pushing up unemployment, how to ensure economic growth to be spread evenly across the country, how to tackle the problems of corruption and crime that the new wealth has inevitably engendered, and how to deal with the 200 million Chinese people who still live in poverty. These internal problems will remain the focus of the government for many years to come: Taken together, they mean it is unlikely that China will choose to assert its dominance on the international scene in a heavy-handed way.

> **"It will be difficult for other countries to compete with China in low-cost light manufacturing but India's skills in software and design are strongly complementary with China.**
>
> **Dr. Leslie Young**
> *Chinese University*
> *Hong Kong"*

Chang opines that its state-owned enterprises and banks are not ready for increased competition. The economy, in reality, is stalling, not growing fast enough. The result is unrest among workers and peasants. The Central Government's finances are in bad shape, and one day the PRC could run out of money. But before that happens, the rulers of China will run out of something even more precious—time.

These trends have been raising a serious question: Is the present growth sustainable? If growth slips further, the central leadership will have to struggle to maintain order. Today, the number unemployed and underemployed probably

exceed the combined population of France, Germany and the UK. However, Dr. Linda is optimistic about growth rate sustainability. She says "China does have deep structural problems, including rising urban unemployment, surplus labor, deflationary pressures deriving from the East Asian region, an inaccurate stock market, high levels of non-performing loans held by state-owned banks, and low aggregate demand stimulated primarily through government investment. Lack of a strategy for dealing with unemployment besides demand management evidenced by the government's fiscal stimulus package and impotent microeconomic policies including ineffectual employment centers pose the greatest challenge.

The risk of corruption and lack of a reliable legal framework increase the uncertainty of the economic environment. Although these problems are substantial and reflect the 'hard' portion of China's gradual reform strategy, China is in a good position to continue to grow at 7-9% per annum." She further adds, "China has exhausted many of the features of an extensive growth strategy and will begin to depend on the infusion of technology typically gained from more developed countries before it can enter an intensive growth phase. By acceding to the WTO, China is well-placed to grow, as it will integrate into the global economy. Moreover, its high savings rate plus large potential domestic market will make it an attractive partner for many other countries. The mutual benefits to be gained have only begun to be explored."

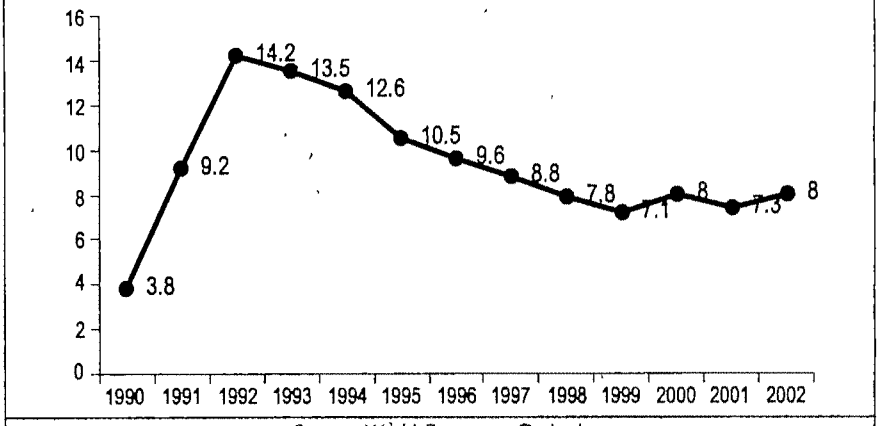
Echoing similar view, Aurora says, "There is little doubt that price deflation and widespread unemployment/underemployment represent major policy challenges for China. Price deflation has been aggravating the health of China's banks, which are creeking under the weight of a substantial bad debt burden. Managing the expectations of China's vast workforce smoothly amidst rapid technological change and restructuring of the state-owned sector is a gargantuan task." He further adds, "these limitations, however, are insufficient to jeopardize China's economic growth rate in the near term. Its resource base and current per capita income level suggest that China still has enormous potential for economic growth before it can reach its peak. Indeed, the pressure to 'pump out' vast quantities of goods with little regard for profitability is precisely what's creating a deflationary problem."

The Chinese economy is competitive not because of its profitability but because of its abilities to survive loss

Going by these realities, China's problems of unemployment, bearish capital markets and falling prices will not sustain production of the existing producers for long. But the Chinese economy does not quite run in the manner of a usual economy. Says Dasgupta, "The moment one line of production collapses, 10 other lines of production emerge to offset the drop in activity. Chinese producers are being born all the time and capital is forever shifting bases from one enterprise to another. However, a coming collapse cannot be ruled out. We should not think that the low capacity utilization, laid-off labor and high debts of enterprises are reasons for the Chinese economic collapse. In fact, the grain of truth in the Chinese success story is that China has been able to withstand these features that are common to the economic enterprises all over the world now. The Chinese economy is competitive not because of its profitability but because of its abilities to survive loss."

Some economists calculate that China could be contributing almost 2% to world growth within 10 years, and half that amount again to world trade. China is set to grow exponentially into the foreseeable future. Goldman Sachs expects membership of the WTO to boost Chinese foreign trade by $800 bn every year to 2005. The effect is to increase competition in Western markets, put pressure on employment and growth there. As China's size within the world economy grows, so will its influence, in the way that its domestic economic decisions will affect the rest of the world economy.

China's GDP Growth (%)



Source: World Economic Outlook

A threat to American predominance?

Though optimists predict China could surpass the US as the world's largest economy within decades, doomsayers point out that many state-run companies and banks here could go quickly bankrupt without huge flow of cash from government coffers. The threat that China might pose to the American economy is not really through its size. It will be very long before China does so. The threat that China really poses for the American economy lies in its abilities to undercut prices. The Chinese goods have today almost displaced American manufacturing. China will not out-compete the US, it has the danger of sabotaging the US economy. "China is still on track to become the world's next economic superpower, if it carries through with the painful economic reforms that lie ahead," says William Overholt, in his book *China: The Next Economic Superpower.*

Whatsoever, American dominance is achieved on many levels of economic performance. China's phenomenal growth reflects in some respects its low level of growth. China's own projections of growth at a rate of 8% will achieve the standard of $3,000 real per capita GDP by 2020. Says Dr Linda, "If the growth rate is indeed achieved, then China will be at the level of a moderately developed economy. Thus, despite the fact that world rankings place China as sixth in the world's largest economies by GDP in 2001, the per capita figures and other structural issues inherent in a transition economy preclude the conclusion that China will dominate the US in the next few years."

This seems to be difficult in the near future going by the facts that China's moves toward capitalism and increased trade have fostered a shaky banking system and an over inflated stock market 'bubble'—the same problems that are muting once-roaring tiger economies from Thailand to South Korea. "Bad debts in China may be larger than those in South Korea and South-East Asia", opines Huang Yasheng, an expert on the Chinese economy at the Harvard Business School in Cambridge, Mass. The net worth of these banks is probably negative," says a recent report issued by the World Bank.

Experts say that in China's half-reformed economy, a great wall of isolation still surrounds its financial system, created decades ago when the communist giant was cut off from the West. This isolation so far has protected China from some of the global economic forces that are exposing weaknesses in more-open markets. Echoing similar views, Aurora observes, "Notwithstanding China's rapidly growing importance in the world community and its global ambitions, it is still too early to categorize its economy in the same league as the US. This is not to minimize China's impressive economic achievements to date, which have been considerable.

If a direct comparison were to be made using a broad variety of socio-economic parameters—for example, level of political or institutional development, investment in human capital, degree of financial sophistication, openness of capital markets—it would indicate that China and the US are far from approaching parity."

In spite of its fast growth and tremendous scale, the Chinese manufacturing sector has a long way to go to compete in an international context. The manufacturing sector has many frailties—the most glaring is the amount of surplus labor and high numbers of laid-off (Xiagang) workers. There are also severe problems of overcapitalization in heavy manufacturing and low profitability on account of 'soft' budget constraints—state-owned enterprises rely on government

> **"The first and immediate impact of China's growth will be to sustain the health of international capital. The growth of China will indeed have a deep impact on the global economy by sustaining the returns to capital that faced problems with recession in South-East Asia and Latin America."**
>
> **Susmita Dasgupta**
> *Deputy Economist*
> *Economic Research Unit*
> *Joint Plant Committee (Steel)*
> *New Delhi*

support explicitly or implicitly. The reform of the state-owned sector is one of the most important parts of the Chinese agenda. There are industries, such as automobile manufacturing, in which these flaws are most noticeable. China does not have a significant car manufacturing industry compared to other industrial economies. This is attributed to the lack of supply chain crucial for assembly and highlights the weakness of lack of external economies of scale of Chinese manufacturing. However, China's position as the largest exporter of manufactured products in the developing world is achieved by possessing a broad range of technologies. The speed of its ability to diversify and upgrade heralds is its likely ascendancy to international levels.

There has been an immense amount of attention to the state of Chinese statistics in recent years. "Under China's accounting rules, almost anything can be made to look profitable," opines Chang. However, since the late 1990s, Chinese statistics have been

India vs. China on Global Arena

Compared to China, India really has a long way to go China has more coherent leadership, is more business-friendly and a much stronger international profile, so it will vault ahead. India has world-class intellectual skills and the advantage of English fluency but needs to simplify its business environment. India relies too much on the skills of individuals whereas China relies on its ability to organize skilled labor to build up enterprises and invest capital. "In India, the social capital is far below the level of China and this is the only reason why I am not sure that we will be able to find our way in the Chinese path," opines Dasgupta. As things stand today, China is way ahead of India in terms of presence in the global marketplace For example, China's share of world exports is nearly seven times that of India's The discrepancy in terms of FDI volume received is also substantial, even after adjusting for potential exaggeration in the numbers reported by China.

In terms of economic potential and global aspirations, however, China and India are both giants Each country has a considerable pool of resources at its disposal, which if harnessed and channeled appropriately, could be used to catapult each country towards their true potential "To date, each country has used starkly different strategies for generating growth and development. In each case, the pace of economic progress has been divergent and the pitfalls associated with each strategy are also not similar," opines Aurora India's experience with economic liberalization is more recent than China's, it is more prone to political roadblocks India's is still a relatively insulated economy compared to China, which has already shown a remarkable ability to integrate itself into the global economic marketplace It is important to note that simply having an economy that is valued at a trillion dollars does not equate with general prosperity Both countries have critical milestones that need to be reached in the form of enhancing productivity, transparency, participation by many, financial-savvy etc., before they can credibly be incorporated into the club of prosperous nations.

Dr. Linda is optimistic about India's prospects as it shares many of the features of the Chinese economy Both countries have large population, mostly rural with urban centers of industry, a commitment to education even if only a portion of the population possesses high levels of human capital But, perhaps most importantly, both countries share a focus on the importance of science, technology and promote industries, which incorporate advanced skills. Dr Linda adds, as technology is the key to growth, with continued commitment on this front, it would be not unexpected for India to become the next success story

accepted by the World Bank as sufficiently accurate for the bank to base its assessments of GDP and other measures. Moreover, trade and capital flow figures from China's trading partners can verify many of the figures concerning the phenomenally successful external sector. Dr. Linda opines that "although there are two major types of errors in Chinese statistics (measurement which is expected for a country of its size and political incentives to report success under a decentralized socialist economy), anecdotal observations of the immense gains in standard of living verify the economic success of, particularly urban China. I do not subscribe to this view but find China to hold substantial economic prowess."

Outlook

No doubt that the rapid industrialization of China will be a problem for other countries. If one does not consider the obstacles, the focus should be on the great benefits of China's growth. Millions of consumers in other countries are gaining from the lower prices and high quality of Chinese goods. Businesses across the globe will profit from supplying a vast new market.

In view of the progress of the past 20 years, the Chinese people apparently have higher expectations for the next 20 years. However, it has its own internal problems, like most of the state-owned enterprises were notably unproductive, which cannot be closed down without a radical change of banks and welfare system. By 2005, some 75% of China's industrial economy will be in private hands, compared to less than 10% in 1980.

Today the market almost controls 98% of prices, the state only 2%. A China-based analyst predicts that unless something is done the pension liability could reach almost 400% of GDP by 2030. China, after all, has just passed the US as the world's biggest magnet for foreign direct investment; the world is ignoring the realities of China. Chang observes that China is suffering deflation because except for telecommunications there is too much capacity Overcapacity in China is matched by overcapacity in the world today When the waves of imports flood China, it is unlikely the GDP will continue its current pace. Bottom line is that there will be some increase in foreign investment, but the boom will be smaller than predicted and shorter than expected.

Whatsoever, the Chinese economy has been steaming ahead marching much better in terms of growth than the once-booming US economy However, this doesn't mean China measures up to the US when it comes to GDP—it is still 10 times smaller and it will take another couple of decades before it can match the largest economy in the world.

N Janardhan Rao

Reference # 1-2003-04-04

CORPORATE DELISTINGS

Means to go private

Given the turbulent stock market conditions and pessimistic predictions, many companies are now considering it worth to go private than remain public.

The 1990s saw companies raise money from primary capital markets with ease. The burst that had followed made raising money from primary capital markets a costly affair and as a result, the demand for IPOs and mergers depressed. Flow of capital from stock markets has dried up and many firms, which have performed exceptionally well in the past, are now being traded miserably. Stockholders are treating stocks in their portfolio with suspicion and this makes life tougher for publicly traded companies. The same companies, which were considered foolish to remain private without going public during the heydays of the stock markets, are now thinking that remaining public will be equally foolish. This is making the case for going private stronger than it had been in the 1980s.

Many small firms have gone private in the past few years and it is now the turn of bigger ones. Southern Waters and Brake Brothers, the Britain-based firms, were taken private by wealthy investors. Dole Foods, the US food giant, was also delisted after its chairman bought it for $2.5 bn. There are even instances where bits of big companies were made private, like Burger King of Diageo being sold out to Texas Pacific. In India too, this phenomena of going private after delisting from the local stock exchanges is being seen very often in recent times, mostly by the MNCs. Many Indian firms like Godrej and Sterlite are also contemplating plans to delist and go private.

Driving factors

The option of delisting and going private evolved during the burst of the dotcom bubble, when many of the technology companies, which had raised capital from the stock markets in the initial stages of their life cycle, failed. Normally, companies that have the potential to make a profit after a phased restructuring would opt for going private. This implies that they have enough money to finance their operations during the restructuring phase.

While the first and foremost reason for companies to go private is the present crisis like situation in the stock markets, where the stock price of almost every company has taken a beat and are now being traded at their lowest levels. Under such circumstances, companies no longer see any advantage in remaining public, which would only result in further humiliation. So, they choose to delist and go private as a better strategic option. By going private, companies to some extent can ward off the disadvantages associated with the weak share price and poor liquidity, i.e., weak share price means bad shareholder sentiment, which might trigger an unwanted hostile takeover bid and also the prospects of raising fresh capital becomes bleak.

Second, by going private, a company gets that vital flexibility to restructure its shattered business quickly that too without being accountable for the shareholders and regulators. Such companies cannot rebuild their businesses in the presence of the harsh glare of Wall Street analysts and stockholders, where even a small mistake would further tumble the confidence of the employees, customers, investors and finally their share prices. So, to avoid these unwanted consequences, the tech companies have found better prospects of restructuring in being private rather than to remain public. Micron Technology and Aprisma of Enterasys Networks are some of those companies, which have moved out of Wall Street quoting this purpose.

Given the high costs associated with the listing, the option of going private enables companies to avoid the financial and human costs associated with a public entity. In the current year, Ninian and Lester, a Durban-based textile firm became the first company to

terminate its listing, citing listing costs as the primary reason for going private. Finally, stock markets are now passing through a peculiar phenomenon called as 'irrational pessimism' and during such periods, normally shareholders and investors would be much more vigilant than ever. To avoid this extra scrutiny on their operations, managers prefer to exit from the markets. Normally, such companies are self-reliant in terms of cash flows and they only take advantage of the declining share prices.

Dr. V V L N Sastry of First Call India Equity echoes the view. "The main reason for companies opting to delist and go private is the attractive low prices at which their scrips are being quoted, making the acquisition costs so low for the promoters to buy-back and get them delisted. Also, the increasing requirements of stock exchanges in terms of disclosures and also the increased thrust on corporate governance are the other reasons for the momentum in corporate delistings and going private."

But all said, the problem lies in the fact that many companies prefer to go public in their initial stages, taking advantage of the boom in the stock markets (as was evident during the 'tech mania' of the 1990s), when the shareholders do not have any clue as to what the company and its operations are all about and by the time they get to know about the company, the damage might have been done and the company is left with the only option of going private with a dubious record in the markets.

Delisting blues

Going private is not smooth. For a publicly traded company to go private, first it has to get delisted from the stock exchange on which it is traded. For this, the company has to buyout the stocks held by its current investors. This needs huge sums of money, even when the markets are depressed, because shareholders would not let their shares go without any considerable premium. The challenge thus is to raise the funds required to finance the buy-backs.

There are both advantages and disadvantages with the option of going private. On the positive side, companies can get off with the quarter-to-quarter earning expectations of the shareholders and market analysts. The downside would be the inability of the company to further tap public markets for funds in the future. Another shortcoming is that private companies can be let down by huge debts, because all financing is to be done only through debts. The problem thus is that while companies prefer to go private when they are struggling and once they are privatized they usually run down with massive quantities of debts.

But, this is ruled out in many cases because those, which do not have stable revenues, good brand recognition and a realistic business model, dare not to go private. "As the very origin of any buy-back or premise for delisting is the surplus cash flows available with a company, it is a clear indication that the company has created good revenue model for itself and it does not find the necessity of listing as a mark for its valuations and it does not foresee any future fund raising. Hence they go for delisting," observes Dr. Sastry. There have been many successful companies, which have turned around positively after delisting and going private like Seagate, which was bought out by Veritas Software, which retained Seagate as a private entity.

As long as the company quotes fair prices for such offers, there would not be much negative impact on the shareholders because of the buy-backs and open offers. The listing provides an opportunity to trade by the shareholders for exit purposes. Delisting after open offer and necessary price paid makes the shareholders to look for alternative investments. Dr. Sastry is of the view that overall it does not harm anyone if the buy-back and delisting takes place after the company being listed for a substantial period of time, wherein it has given the necessary returns to its shareholders over a period of time either in terms of capital gains through vibrant secondary markets or through buy-backs.

> **"Overall it does not harm anyone if the buy-back and delisting takes place after the company being listed for a substantial period of time, wherein it has given the necessary returns to its shareholders."**
>
> **Dr. V V L N Sastry**
> *President, First Call India Equity*

"In the absence of any such returns to the shareholders, delistings prove to be disastrous for the shareholders, if the promoters resort to buying back the shares on the basis of prevailing low market prices and resorting to delisting soon after listing in a short span of time", he adds, while warning that if a particular company's scrip is going for delisting at an offer price based on the market average prices prevailing without giving any chance to shareholders to trade and earn money, in such cases any delisting may prove to be harmful to the shareholders.

The Indian scenario

There has been a trend over the past couple of years, where many multinational companies have been buying their shares from Indian domestic shareholders with the obvious intention of getting delisted from Indian bourses and operate as fully-owned private entities of their foreign owners. Kodak India, the market leader in the photographic equipment in India, is the latest Indian subsidiary of an MNC to

delist and become a wholly-owned subsidiary of Eastman Kodak of the US. Prior to Kodak, companies like Cadbury, Carrier Aircon, Otis Elevators, ITW Signode, Ciba Speciality Chemicals are some of the MNC companies, which have delisted from the Indian bourses taking advantage of the crash in the stock market prices in 2000 and 2001.

The 'strategic' motivation that is driving these MNCs to delist is that they no longer have the need or wish to raise money from Indian markets. If not for the government listing regulations, these would have never listed in the Indian bourses. While in the 1980s and 1990s, MNCs were forced to go public and reduce their stake in their Indian subsidiaries from 100% to about 40%, the post-liberalization era favored MNCs to increase their stake to 51% and then to 74% subsequently. Also, in the beginning of 2002, the government removed holding restrictions by MNCs and allowed them to hold 100% in many key areas. Another factor is that MNCs prefer a single holding company with wholly-owned country operations, as it would facilitate an optimal global operation system wherein, they need to focus only on their business without dealing with the interests of minority shareholders at different levels across various countries. With the government regulations governing MNC operations in India, also favoring the buy-back and open offer phenomena, the few listed 'quality' MNC stocks are also opting to get delisted and go private. Many Indian companies are taking cue from their overseas counterparts and are planning to delist, again quoting the trembled markets as the main reason for their delisting and 'going private' moves. Given this situation, it can be said without any doubt that the universe of listed stocks is rapidly shrinking and this is no good news for the average Indian investor who would be left with no quality stocks to invest in.

Guidelines based on the recommendations of the committee set up by SEBI to tighten delisting norms.

- The national and regional stock exchanges are vested with the authority to monitor the possibility of price manipulations and keep a watch on the securities that announce delisting.
- The guidelines make it compulsory for companies to determine the exit price for delisting of securities in compliance with the book-building process, also known as reverse book-building through an electronically-linked transparent facility.
- The offer price would be the average of 26 weeks traded price preceding the date of announcement of delisting. The final offer price is determined as the price at which maximum number of shares has been offered.
- The promoters or the acquirers of companies who wish to delist their stock should obtain the prior permission of the investors through a special resolution passed at the general meeting.
- Delisting would be permitted only if the company is listed for a minimum period of three years.
- The shareholders would be given an exit opportunity and the exit price would also be determined in accordance with the book-building process.

Keeping in view the dire consequences that investors would be left with because of the delisting of their Indian subsidiaries by the MNCs at dirt-cheap prices, the Indian market regulator, the Securities and Exchange Board of India (SEBI) has instituted a 12 member committee under the chairmanship of Pratip Kar, Executive Director, SEBI to suggest guidelines in an effort to tighten the norms for delisting of companies with the objective of providing better options to investors. Accordingly, the committee has recommended a set of guidelines (see box), which propose tight delisting norms for companies. SEBI has accepted the report submitted by the committee and has issued two sets of norms—SEBI (Delisting of Securities) Guidelines 2003 and SEBI (Central Listing Authority) Regulations 2003. These norms took effect from mid February.

A viable option

Freedom to operate without any interference from either the public or the regulators is a motivation to go private. Also, being private fetches another major advantage for companies—freedom from lawsuits by the shareholders. Given these major advantages many firms are now viewing the option of delisting and going private as a viable way of doing business independently without facing any pressures and protests from the shareholders for each and every action. Again, it all varies from company to company, says Dr. Sastry. He opines that going private depends on the company's strength on a case-to-case basis and promoter's inclination to be a part of a public eye through various disclosures and increased corporate governance norms. Those who can comply and feel the necessity of listing will tend to continue and those who are all cash surplus or find cash avenues for buy-back will tend to go for buy-backs.

Then again the fact that taking out companies from the scrutiny of the public would spur the suspicious activities of companies. It would also increase the inclination of the firms to engage in fraudulent and irresponsible business activities. But, this would have an impact only on the professional financiers and the management of the firm, which indulges in such activities and not the shareholders. However, when one looks back, it cannot be argued that public companies have become symbols of decency and honesty either.

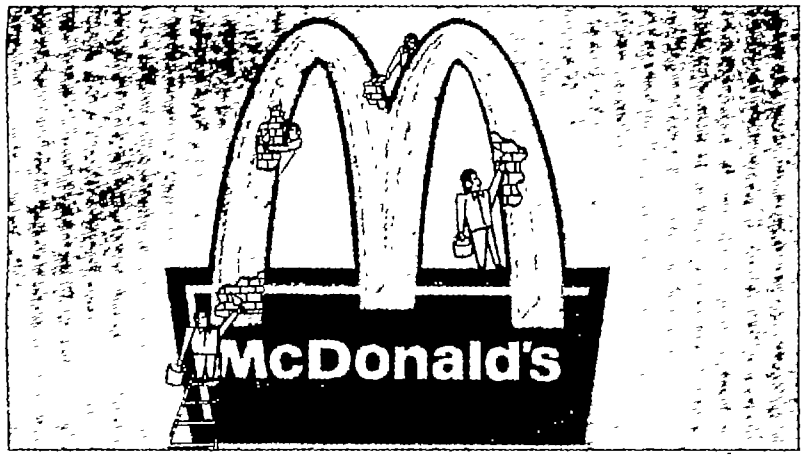
Ramakrishna Neti

Reference # 1-2003-04-05

McDONALD'S

Where did the magic fail?

McDonald's Corporation, the pioneer in the quick service restaurant concept is in turmoil. It rose from a single outlet in a nondescript Chicago suburb to become an American icon. But today, McDonald's is a reeling giant that teeters from one mess to another. Where did the big Mac's strategy fail?



Ray Croc started McDonald's in 1955 in Des Plaines, III, US. During that time, the socio-economic conditions prevalent in the US propelled the growth of McDonald's. Large number of women entered the job market and hence had less time for cooking at home; inflation-adjusted value of the minimum wage declined by about 40%, sophisticated mass marketing techniques were for the first time directed at small children, and people were more inclined to dine outside, at places that provided quality food and better service. Sociologists Cameron Lynne Macdonald and Carmen Sirianni have noted that the entry of so many women into the workforce has greatly increased demand for the types of services that housewives traditionally perform, such as cooking, cleaning, and child-care[1]. This jelled well with its campaign "You Deserve a Break Today" targeted at working mothers and with its USP, which are Quality, Service, Cleanliness and Value (QSCV). Competition was also minimal.

Piggybacking on the growth of the fast food industry in the past, McDonald's opened thousands of Mac stores both in the US and in other countries. According to Dr. Lisa N Penaloza, Associate Professor of Marketing, Leeds School of Business and Faculty Associate, Office of Diversity and Equity, University of Colorado, Boulder, "McDonald's has benefitted from positive sentiments in the world for the US as a nation and for its cultural mix of democracy and capitalism, as well as the growth worldwide of a middle class. The company's formula for efficient, mass produced meals as the basis for their value worked fairly well at home. Abroad, they used a premium price and benefitted from the upper middle-class."

But the erosion of McDonald's profitability did not happen in one day. Since 1997, McDonald's market share in the fast food industry has fallen by more than 3%. Over the last few years its earnings were also not meeting the shareholders and Wall Street expectations. In 1998, McDonald's posted its first-ever decline in annual earnings. The company posted its first quarterly loss of $343.8 mn for the quarter ending December 2002.

The changing scenario

Though McDonald's is present in 121 countries, four-fifths of its worldwide income is generated from four markets: America, Britain, Germany and France. All these four markets are in the maturity stage. An interesting point mentioned by Dr. Penaloza is that "the dependence of most McDonald's restaurants on US tourism in non-US locations (for profit and growth). Typically they are located near major tourist sites, yet tourism has fallen off significantly since 9/11."

The US market accounts for more than 50% of McDonald's operating income, and the burger market is growing at an annual average of just 2.7%. Growth in the consumer spending in the restaurant industry as a whole has also decreased in the US (2000 – 4% vs. 2002 – 2%). Quick meals of different types are also found in supermarkets, convenience stores and even in vending machines. Customers no longer have to go to Mac stores. McDonald's per-store sales in the US fell by 2.8% in the third quarter of 2002.

Competition

In this matured and low growth industry, McDonald's has many

[1] Schlosser Eric (2002), "Fast Food Nation: The Dark Side of All-American Meal," *HarperCollins.*

competitors, such as Wendy's, Burger King, Taco Bell, Pizza Hut, KFC, Subway and smaller players such as Rubio's Restaurants and Jack in the Box. Though not all of these fast food chains offer similar menus as that of McDonald's, yet they are competing against each other to get the maximum share of the customers' wallet. Wendy's offers menus featuring, baked potatoes and a salad bar while Burger King offers burgers both of which have captured many of the McDonald's lunchtime customers in the low growth industry. On the other hand, Subway, a fast food company offering custom-made low-fat freshly-baked sandwiches has also weaned away many breakfast customers from McDonald's. The nutritional benefits of low-fat sandwiches that taste good has enabled Subway to achieve high growth that made Subway the largest fast-food chain in the US (14,000 stores vs. McDonald's 13,000 stores). The better and tastier menus offered by Wendy's and Burger King and the freshness angle of Subway's sandwiches have long scored high in the customer satisfaction surveys in the US.

The fast food industry in the US is also facing competition from other dining options (more than 900,000 are available), such as 'fast-casual' and exotic foods like sushi and burritos. The 'fast-casual' restaurants, such as Schlotzky's, Panera Bread and Boston Market have emerged as a new way of dining for the Americans in 2002. These restaurants, which fall between the 'quick service' and 'full service' segments offer customers an option of having a sit-down meal, healthier menus, higher quality, fresher more varied food and a different in-store experience than that of traditional fast food restaurants without having to pay the premium price of a more upscale restaurant. This segment is witnessing a high growth (12%) from the baby boomers who are looking for healthier, more tasteful alternatives to fast food staples such as burgers and fries. Consumers also have the perception that the 'fast-casual' restaurants offer 'healthier' food options compared to the burgers and French fries selling restaurants.

Changing food habits

With Americans becoming more health conscious, their food habits have also changed. Customers now demand fresh and not pre-packaged food with high-quality ingredients. Consumers are thinking twice before eating about the amount of fatty foods they should consume affecting the sales of fast food chains such as McDonald's, Burger King and Wendy's. Allan Hickok, a restaurant analyst with US Bancorp Piper Jaffray viewed, "Americans are not eating as much fried food as they used to, and the aging population is behaving differently than they did 10, 20, 30 years ago, and that includes their diet.[2]"

There was widespread customer dissatisfaction and consumers also complained that McDonald's has not changed its menu with the changing customers' tastes. The standardization and the assembly-line system that offered the same type of food to customers hindered the growth of McDonald's as consumers' tastes and expectations changed in the US. For example, on the University of Michigan's American Satisfaction Index, McDonald's has finished last among the fast food restaurants every year since 1992.

Health problems

Obesity has now become US's leading health problem. A recent report in the *Journal of the American Medical Association* showed that 30.5% of Americans are obese and 15% of children aged between six and nine are overweight. Fast food with high-calorie and artery clogging junk food has long been associated with obesity and other health-related problems. Dr. Penaloza views, "McDonald's core offerings, the hamburger and French fries are not generally perceived to be healthy. Scares about Mad Cow Disease also work to create a negative aura for the company's offerings." Concerned about health, anti-obesity campaigns have started which would have a negative effect on the fast food industry. The Mayor of New York, Michael Bloomberg, had vowed to reduce obesity in children. As a result, three New York City hospitals might not renew the leases of McDonald's franchises next year. The Food & Drug Administration of US has drafted a rule that would require labeling of foods with trans-fatty acids (found in oil used for cooking fast foods). Obesity lawsuits have also been filed against McDonald's, which though rejected by the courts, nevertheless dented the image of the company.

The internal problems

Too much expansion

Over the years, McDonald's has expanded too much that it ran out of room to grow. In the past, the company opened new restaurants at a rate of 1,000 across the world. It has 13,000 Mac stores in the US and 30,000 worldwide. Too many stores have also resulted in cannibalization of its own customers. Dick Adams, a consultant to 500 McDonald's franchises in America opined, "As the industry becomes more saturated and more competitive, the constant struggle to build topline sales becomes more difficult for the franchisee.[3]"

Poor service and quality

Over the years McDonald's has lost its competitive advantage in service and quality, the two core components of its USP. In 1990s, when McDonald's expanded rapidly,

[2] Zuber Amy (2002) "Discounting Not a Quick Fix for Fast Feeders," www.nrn.com, November 25.
[3] Day Sherri (2002), "McDonald's Cuts Forecast and Will Close 175 Outlets," www.nytimes.com.

it stopped grading its franchises for cleanliness, speed and service. Training declined as restaurants fought for workers in a tight labor market. In 1992, McDonald's abandoned the method of precooking its burgers, dressing them and setting them underneath warming lights. Instead, a new system was adopted that required an additional step of warming the burgers in a microwave oven before they were served. Then in 1999, the company introduced a made-to-order system, called 'Made for You' to counter custom-made food systems at Wendy's and Burger King. However, both the systems instead of improving the service time considerably slowed the time required to serve its customers. The mystery shops indicated that McDonald's met the speed of service standard only 46% of the time and that three out of every 10 customers had to wait more than four minutes to complete the order.

Research has also found that rude and slow services, unprofessional employees and inaccurate service are the source of vast majority of customer complaints. A survey in 2002 by Global Growth Group, a market research company, showed that McDonald's (163 sec) came third in average service time behind Wendy's (127 sec) and sandwich shop Chick-fil-A (151 sec). In 2001, in a survey by *Restaurants and Institutions Magazine*, respondents ranked McDonald's 15th in food quality at hamburger chains.

Un-innovative

McDonald's is considered to be an innovative company, which gave America the first fast food restaurants; salad shakes; Big Mac, the first extension of McDonald's burger; a drive-through window eating style; and Happy Meals with toys. However, both analysts and consumers viewed that McDonald's has now become un-innovative. It failed to offer its customers a blockbuster new product since the Chicken McNugget in 1983. Though, in the recent past, McDonald's attempted to introduce 40 food items, such as spaghetti, lasagna, pizza and carrot sticks, most of them failed. McLean sandwich and Arch Deluxe burgers were the biggest flops.

Franchisees

Over the years McDonald's has developed its franchise system as a lucrative business model in the fast food industry. McDonald's rent the franchisees the location (land and buildings are owned by McDonald's) and demand high corporate standards in return for a certain percent of the gross sales from the franchisee. Further, McDonald's has a very strong franchise agreement biased in favor of McDonald's. If a franchisee does not adhere to McDonald's high standards, McDonald's has the contractual power to remove the franchisee out of the system.

However, the lucrative franchise system is now in trouble. While previously, people queued to take McDonald's franchises, 20 franchisees are now leaving McDonald's every month. As a result, McDonald's took pre-tax charge of $292 mn in the fourth quarter of 2002 for closing the restaurants. Many have complained that the ownership of McDonald's restaurants is no longer profitable. Opening a McDonald's franchise costs a franchise between $500,000 and $800,000, profit margins have dipped (4% against 15% during the peak time), costs have increased and the corporate management had largely removed the franchisee from the decision-making process. Expensive new cooking system is another factor. McDonald's had asked the franchisee owners to increase staff during lunch hours to speed up service, increasing the costs of the franchisee. However, franchisees blame 'Made For You' program for slowing down service times. In addition, to implement 'Made For You' program, the franchisees had to overhaul their kitchen set-up, which according to McDonald's would cost them $25,000 per store, out of which McDonald's would bear half the cost. But in reality, the cost overran $25,000 and as a result, the franchisees had to bear the extra cost.

> **"McDonald's price-based competitive strategy not only erodes the value of its offerings, but it also erodes their profits across the board."**
>
> **Dr. Lisa N Penaloza**
> *Associate Professor of Marketing*
> *Leeds School of Business and*
> *Faculty Associate*
> *Office of Diversity and Equity*
> *University of Colorado, Boulder"*

Pricing

McDonald's decision under its previous CEO, Jack Greenberg (Greenberg) to sell a full size Big N'Tasty and McChicken for $1 each; and a new $1 Value Meal that includes both the above and six other food items did not help to increase its revenues. Instead, it led to a price war with its competitors. Burger King introduced its 99-cent Value Meal consisting of 11 food items. The Big N'Tasty burger actually costs the franchisees $1.07 to make. Hence instead of promoting the Value Meal at $1 some of the franchisees sell it for $2.25. Dr. Penaloza questions the logic of the price-based competitive strategy of the company. According to her, "not only does it erode the value of McDonald's offerings, but it also erodes their profits across the board. Thus slimmer margins support the company's infrastructure, at the same time its price-quality relationship is altered, and its volume of sales is decreasing."

Wrong strategies

Once McDonald's offered a pizza that did not fit through the drive-through window and salad shakers that were placed so tightly that dressing could not flow through them. It also failed by introducing wrong food items to its menu such as Arche Deluxe burger, McLean sandwich and Campaign 55 for a reduced price of Big Mac ($0.55). In late 2002, McDonald's top management directed the US franchisees to remodel their restaurants, such as having red roof, apply fresh paint and install better lighting. However, analysts have questioned the viability of such direction on the part of the franchisees as they in 1998 had spent huge amount for a remodeling program.

Critics have also blamed Greenberg's style of leadership, doing so many different things but with poor execution, like the 'Made For You' program. Under him McDonald's also diversified into 'fast-casual' segment by acquiring Chipotle Mexican Grill (1998) and bankrupt Boston Market Corp. (2002), but he failed to develop the new ventures while also improving quality getting the new kitchens rolled out and developing new menu items at the same time. After remodeling Boston Market restaurants and upgrading its home style menu, McDonald's opened only 17 new restaurants in 2002. Greenberg might have also made the mistake of concentrating on small German market ($5 bn) to develop McDonald's Donatos Pizzerias instead of the US market ($24 bn).

Future outlook

Jim Cantalupo has taken over as the CEO and Chairman of McDonald's from Greenberg in January 2003. He was the man behind McDonald's growth in the 1980s and 1990s. Under his leadership, McDonald's is focusing on getting customers back into their restaurants. Towards that direction, the company is planning to introduce new food items like a salad topped with hot slices of grilled or crispy chicken; McGriddles; McCafe, fruit juice; apple slices; and others.

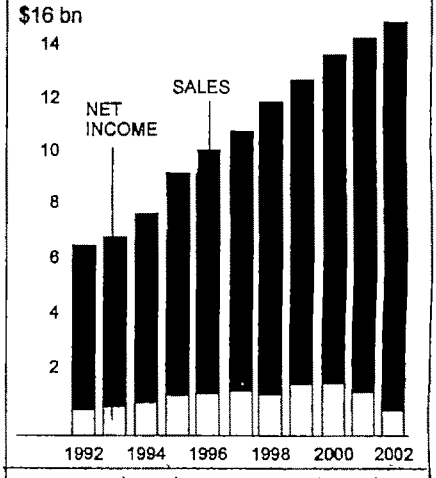
He has also stopped an ongoing multi-year technology project, called Innovate, thus saving millions of dollars. It is also planning to resort to its old way of toasting buns to get the flavor right. The company is also trying to score high in service, speed and quality parameters, by reinstituting a tough 'improve or out' grading system. It is planning to use new oil developed with Cargill for its fried foods. It is also promoting heavily its $1 Value Meal, for which it has earmarked $20 mn for ad campaign McDonald's has also started testing its customer loyalty program, called McDeals in Hawaii in October 2002. McDeals is an innovative way to provide McDonald's customers with relevant purchase incentives, offers and sweepstakes which are customized to individuals and are delivered at the point-of-sale.'

Besides introducing new food items, McDonald's under Greenberg had also entered into non-burger market. It has acquired a minority stake in London-based Pret A Manger sandwich shops besides purchasing Chipotle Mexican Grill, Boston Market and Donatos Pizzeria. It has also signed a letter of intent to develop 20 to 30 restaurants with the Fazoli's Italian fast food chain. Chipotle has generated average sales of $1.3 mn per unit and has shown 20% average growth within the past four years. Cantalupo has to develop and expand these new ventures carefully instead of neglecting them as done by Greenberg earlier. McDonald's top management has also asked its 10 ad agencies to draw up an innovative plan that need to go beyond the ubiquitous Disney movie tie-ins.

After its success in France, McDonald's is also allowing its franchisees in the US to be innovative in designing the interiors of restaurants. A franchisee has opened its Mac store in New York with video monitors that show movie trailers, brick walls, and theatrical lighting. Another franchisee in Oregon, US has installed wood paneling in the dining room of the restaurants and cordoned off a separate space for sofas, vinyl chairs and coffee tables, and a third has modeled the restaurant after a French café, with a chef in a white jacket. However, with sales not increasing, the company also needs to close more than its planned 500 restaurants to reduce costs in location and labor.

Unhappy Meals

Sales growth at McDonald's has slowed and earnings have dropped.



Source: Bloomberg Financial Markets

However, some analysts are skeptical of McDonald's efforts. They feel that entering new markets will not be enough to fix problems in the core hamburger business. They viewed that McDonald's has to reassess its whole business model and positioning.

Whether the magic wand of Cantalupo would help to turnaround McDonald's within 18 months, the time-frame promised by him, or whether McDonald's would be extinct within the next five years as predicted by Philip Lempert[4], food editor for NBC's 'Today' is to be seen.

Anindhya Roy

Reference # 1-2003-04-06

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CHARTERED FINANCIAL

ANALYST

Survey of Emerging Career Trends

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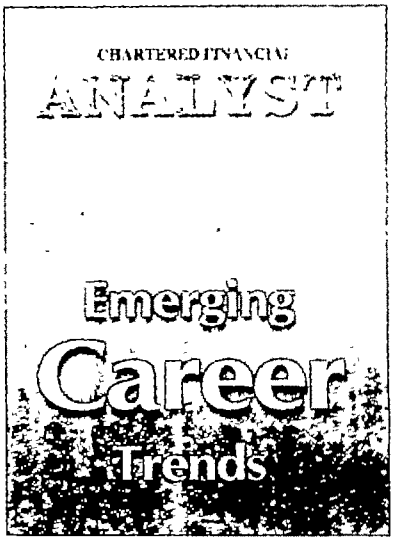

Cover design by A Bangaru Babu

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The views expressed herein are those of the authors and do not necessarily reflect the viewpoint of the organizations with which they are associated.

On a New Trajectory

With the new millennium, new changes ushered in the Indian job market. While traditionally, the emphasis was much on careers in manufacturing sector, the recent developments in the fields of Information Technology led to the development of a totally different job market. This is true both from the individual and the organizational point of view. The change in the Indian job market or careers can be easily understood if one analyzes the trends during the last one decade. Prior to the liberalization of the Indian economy and advent of IT, the job market was dominated by organizations, which emphasized on skills that were required to manage a business in a controlled regime. But with increasing globalization of business environment in India, the emphasis shifted more towards developing and managing business and preferring people with multiple skills. Never in India, there was a crisis for talent and the point is proved again even in the field of IT. While people in US and Europe are being laid off, there is a massive recruitment drive in India. This only underlines the availability of talent pool in India and changing preferences of organizations worldwide.

Thanks to IT, today, there are numerous career opportunities available in India. Since India is growing as a global outsourcing hub, it is estimated that career opportunities as a result of outsourcing will increase by nearly 30% annually. IT-enabled services market is expected to be around $18.6 bn by 2008 employing more than 1.1 million people. New careers were created in the areas of infotech, retailing, media consulting, entertainment, financial services and others. While these new careers were created by the changing business climate, to survive in the competitive world it is essential for an incividual to benchmark his performance from time to time, acquire knowledge about new skills and orient oneself to the changing atmosphere. Undoubtedly, for an individucl with the required talent and performance, there is no dearth of opportunities.

Overall, during the last one year, there is a considerable change in the Indian job market. With IT leading the race, manufacturing sector is expected to bounce back into activity in the coming year. Already, there is a spurt in recruitment activity in telecom, insurance, pharma, healthcare and IT-enabled services sectors. Considering the growth of these sectors in the coming years, it may not be wrong to say that the most lucrative careers will be structured in and around these sectors. And the growth of online recruiting in India will enable the identification of right careers for the right candidate. Though online recruiting accounts for only 3% of the market, it is expected that it will account for more than 60% by the end of 2008. For individuals, the growth of online recruiting is a good news since they can identify the right career at minimal cost and with much ease. At the same time, organizations will benefit through e-recruiting as it provides an opportunity to identify the right candidate at minimal cost and effort. ■

Y Chandra Sekhar
Survey Editor

Executive Careers

Service sector is growing and playing a vital role in the business today. The specialized areas in boom, despite various global factors that affect the businesses, are call centers and BPOs, financial services, bio-informatics and telecommunication sectors.

C S SWAMINATHAN
CEO and Managing Director
Online Recruiters Pvt. Ltd.

The present market scenario is for specialists who deliver results within the fast pace of information revolution. Executive management positions are for the talented lot New rules apply today. Long career paths are dead because stable, mature organizations that enable long career paths are becoming obsolescent due to the accelerating rate of technological change. Today, the *ad hoc* organizational structure, lack of growth in FMCG and engineering sectors have worsened the position of executive jobs IT sector is in a position of stabilizing itself in terms of executive recruitments Here, they need professionals who are not readily available.

What I feel is that people in executive management positions should create their own opportunities rather than wait for it to evolve. Age has nothing to do with today's career options, the jargon is competency not longevity: People should acquire new expertise, totally reinvent themselves from prior identities. Overall, the market is for people who adapt to change

Service sector is growing and playing a vital role in the business field today The specialized areas in boom, despite various global factors that affect the businesses, are call centers and BPOs, financial services, bio-informatics and telecommunication sectors Increase in pay packets of the middle-class especially, has led to their spending more. Their lifestyle is largely improving, so, purchasing power is adding to the increase in financial services Government's policy towards taxes benefits them more

There are many players in the telecom field. Competition and increased reach of services to customers is favorable to this sector Availability of labor at competitive cost has attracted investment of multinationals, to cater to their consumers worldwide in the form of call centers and BPOs. So, large numbers are springing up taking upon the resources available to them

A lot of multinationals are opening up their operations in India

The main reason for MNCs to invest in India despite other favorable factors is the availability of labor at a very competitive cost. They have at their disposal, a skilled and dedicated labor force. The trend will change only a little late, perhaps, in the next 10 to 15 years

A lot has to be done to execute this change Even though Indians are employed and heading positions in leading business houses across India and rest of the globe, some critical factors still remain a hurdle

Some are lack of awareness in global trends, system of education, economic growth, population, Government's role, self-employment and underemployment.

Advent of Internet

Internet is changing the pace of our lives With the opening up of world markets and a highly competitive age of information technology, there is enormous change taking place in the overall business environment

Online recruiting, a development of the information highway has revolutionized the working of traditional recruitment

It has helped the employer to identify his ideal candidate not from a domestic but a global hub of aspiring and competitive seekers The job seeker is able to receive offers straight to his inbox from different parts of the world. The headhunter is able to cater to a large array of both employers and job seekers.

We at Online Recruiters (?) Ltd , bring all the three unto a single platform and help each to cater to his needs The growth of this market segment on the global front is estimated to be $8 bn by 2005

The boom of online recruiting is due to the following economic trends·

- Minimal cost
- Time factor
- Increasing demand fo technology workers
- Shrinking labor pools
- Shorter employment tenures
- Reach in a large scale
- Targeted reach

The future of online recruiting is very bright , Most search engines have the maximum hit for jobsites.

Online recruitment today is complementing traditional media methods but is expected to take over them. Recent trend shows dramatic rise in the marketing of website, online training, dawn of video interviews and emergence of a niche segment of professional Internet recruiters.

There are many caterers in this field but we benchmark ourselves on innovation We assure speed and quality of service be provided to different clientele.

At present, our main services are:

- Résumé distribution
- Job order distribution
- Split placement network

We at recruiters community com distribute résumés across the largest pool of employers and headhunters to place candidates

We help employers to locate their ideal candidate from relevant headhunters across the country. So, employers get a complex network of headhunters at their service who offer a wide variety of résumés to choose from.

Recruiters community.com is revolutionizing the recruitment business by helping recruiters work with competitors, split profits, maximize returns and customer retention The moment of a fine business opportunity slips by because of lack of resources Since recruiters can get candidates available with the competitors to fill up their vacancies and get their candidates the job openings.

Recruiters community now throws open a new world of opportunities for recruiters, by generating a steady online inflow of employer's requirements and candidates

We are planning to add value-added services like online training, résumé preparation, skill enhancement, HR newsletter, job postings, searchable database of candidates etc. ■

Online recruiting, a development of the information highway has revolutionized the working of traditional recruitment

Managing Careers

The paradigm shift of career management from organization to individual has been difficult for individuals to manage. Today, one has to keep abreast of everything that is happening not only in their line of business but also related and associated lines of business.

T SREEDHAR
Managing Director
TMI Network

At the outset, we should clearly understand that careers are managed by individuals and not by organizations any more It is purely up to the individual to keep himself updated and contemporary, in line with the requirements of his existing or potential organization Therefore, the present trend in management careers is driven by individuals

Organizations over a period of time valued loyalty, competency, performance and compensation, not necessarily in the same order As long as the individual was able to execute the assignment, task or a job, he was considered to be good enough for the job Today, the same employers have a different view They have clearly moved towards multiskilling, multitasking, and the ability to scale up Therefore, the organization's expectations have changed while professionals have found it difficult to adapt to this change, all of a sudden There might be many reasons for it. I have noticed that employees have looked upon employers for providing careers and growth and therefore they have been expecting employers to provide necessary training/tooling, which may not be true anymore

With the paradigm shift of career management from organization to individual, it has been difficult for individuals to manage their careers Today, one has to keep abreast of everything that is happening not only in their line of business but also related and associated lines of business He has to know beyond the scope of his job and has to have complete business sense rather than restricting oneself to his function

American thinkers, Alvin Toffler and Peter Drucker have predicted the following changes in the socio-economic life

- 21st century society will be a 'nonsocialist and postcapitalist' society
- Manufacturing sector will lose its importance and service sector will make significant contribution to national income There would be 'service revolution' in the world
- Knowledge and information rather than 'capital' will be the main source of economic development Hence, there would be knowledge workers, knowledge society, knowledge executives etc
- Due to the information technology revolution, future business offices will be 'paperless' And gradually, the business world would move towards 'office elimination'

- Future business organizations will be flat, networking and ad hoc. The organization will be a learning and virtual one.
- The task of personnel managers will be more challenging as well as difficult because management will have to deal with knowledge workers. HRD, rather than HRM, will be the main activity of future managers.
- Factory system of mass production will totally change. Japan has already invented the new approach to manufacturing, i.e., electronic cottages and lean production. Production will be of nonidentical goods. The production system will go beyond mass production and the world over, the corporate sector will face an identity crisis.
- Because of the information boom and communication revolution, there will be a direct contact between consumer and producer and hence, the existing chain of distribution will disappear. Sky marketing, Internet marketing, market ownership, solution marketing, delighted customers etc., will be the new concept of future marketing management.
- Toffler has predicted that the world will turn back into small, isolated, complete, self-sufficient blocks.
- Future careers will be
  - Knowledge-based
  - Information-intensive
  - Highly mobile across the world
  - Highly rewarding and
  - On a fast track
- Indian corporate sector has been rapidly changing.

Because of the information boom and communication revolution, there will be a direct contact between consumer and producer and hence, the existing chain of distribution will disappear

New management education – Act locally

Keeping in mind this future scenario, management education has to be reengineered.

Our future global manager will require the following new skills:

- Information Management Skills
- Information Technology Management Skills
- Decision-making in a very dynamic environment
- HRD Skills
- Innovation/Creatability
- Service Sector Management Skills
- Time Management Skills
- Stress Management Skills
- Environment Management Skills
- Intrapreneurship
- Customer Services Management Skills
- Entrepreneurship

Today's times are marked by intense competition among organizations, very demanding customers, and a market open to not only national players but also global players, and the rat race for advancement in one's career.

There were times when one could see only gray-haired (elderly) persons occupying top positions in the organizations. Nowadays, top positions are manned by youngsters as young as 26 years.

In a scenario like this, managing the organization and the self assume importance. There are no readymade solutions for success in such situations. Each situation calls for management skills of high order.

Ultimately, success comes to those who are not only confident to succeed but also work incessantly towards the same.

With the change from manufacturing-based economy to service-based economy, the skills required have also changed. Professionals with skills in manufacturing-based economy have found it difficult to move to service industry. The individuals are expected to have very high analytical ability, high energy level, passion in whatever they do and the ability to do it faster. Therefore, the organization's expectations are in having people who are younger, who come from good

management schools and the ability to learn on their own and grow

Today, large service sectors like telecom, insurance and IT-enabled service industries are also going through a radical change

Although such segments have had a very short exposure to the Indian market, the boom in the telecom industry is slowly settling with rationalization of its structure, competency, skill and compensation Professionals who migrated to telecom are worried today and so has been the experience of professionals who have gone into the insurance industry Therefore, uncertainty and insecurity have affected the job market in our country However, given the intellectual talent available in India, English as a language, which is quite prevalent in India and our ability to follow a process diligently, have all led to the belief that the ITES industry is a welcome boon to the Indian economy

More and more companies even within the service sector, both domestic and international have been outsourcing to low-cost partners or vendors, thereby reducing the cost of operations While ITES/BPOs originated largely as an export model, more domestic companies are outsourcing in the areas of service marketing, service delivery etc Therefore, we see a tremendous opportunity for us in the ITES sector

Opportunities exist for people who have an entrepreneurial attitude As outsourcing develops into a larger space, we could slowly move into high-end, in the IT-enabled services of the segment as most of the low-end segments will continue to migrate to third world developed countries on costs McKinsey report indicates revenue of about $21 bn by 2008 from $1 4 bn revenue in 2002, with an employment potential of two million people This would generate 10% executive managerial positions, which by itself is a huge opportunity

India is considered to be a very highly intellectual and productive talent base It is also seen as a country, which can move up a value chain in any of the processes Our productivity and intellectual capability, and the ability to deliver it within a smaller time-frame makes us low cost We, therefore, have a talent pool of highly productive employees, which makes us low cost However, this trend will definitely change over a period of time. This segment is catching up across the globe and you will find all third world countries focusing on improving their productivity and delivery levels

I am given to understand that IT-enabled service industry was booming in Israel and Ireland for almost 10 years and now, those businesses have migrated to India Therefore, in a span of 5-7 years time, we could anticipate businesses to move from India to third world countries (it is expected that India will be a developed country much before that)

However, you will notice that many of the global companies are coming to India, to source talent for their domestic opportunities and see migration of skilled talent to US and Europe. This is happening in the banking/financial services industry etc Therefore, it will be unfair to say that we are a low-cost labor and that we are used

It's a fact that our talent has gained recognition and our executive managers today are global managers Indians are paid in the respective local currency and treated as expatriate

To conclude, the individual holds the future He has to have a very good attitude towards work, learning and keep looking at opportunities, which can help him improve his career Leadership and Learning are indispensable ■

Management Careers in IT

S C BHATIA
CEO
Datamatics Staffing Services

With intense competition from China and Korea, there is constant pressure to keep costs low, maintain high quality standards, and adhere to strict delivery schedules. To stay competitive, it is essential to build competencies in domains such as banking, financial services, insurance, healthcare etc., and offer more value-added services to clients.

Executive management careers in IT, in India are getting more domain-specific, with demand increasing for specialists The flip side is that only professionals with high performing and multitasking capacity can survive. Remuneration levels are yet to stabilize.

The IT industry is looking up again If the demand for software professionals is any indication, the market scenario for IT professionals is very upbeat, to register revenues of $87 bn by 2008. India's IT software and services sector will have to educate three million knowledge workers, in the next eight years The number of software professionals employed has increased from 280,000 in 1998-99 to 522,250 in 2001-02.

According to a Nasscom study, 44% of these are working as programmers, engineers, analysts and computer scientists, rest are in the IT-enabled, network design and administration, digital media and database administration and development In the next four years, Nasscom predicts a shortage of at least 64,000 (around 5,33,500 going by their optimistic estimate) knowledge professionals.

One of the reasons for growth is the increase in the quantum of outsourced projects to India, by global organizations in the BFSI, healthcare, retail and telecom segments The demand primarily is for professionals with expertise in the following areas

IBM Mainframes, Sun Technologies: Java, J2EE Architects; Microsoft Technologies· Dot Net, VC++, COM / DCOM...

Professionals in quality testing, IT infrastructure/facilities management are also much sought after There are also large-scale ERP/CRM implementations happening in leading corporates worldwide and consequently there is an increase in demand for ERP/CRM professionals ORACLE Applications, PeopleSoft, SAP, JDE, Siebel

Business Process Outsourcing

With the software services business continuing to be under pressure, Business Process Outsourcing (BPO) has become an engine of growth for Indian infotech majors. According to ICICI Securities, India can acquire a global IT-enabled market share of 13.1% on a price-adjusted basis by 2007, which means a market size of around $9 bn.

With competition hotting up from China and Korea, there is constant pressure to keep costs low, maintain high

quality standards, and to adhere to strict delivery schedules. To stay competitive, it is essential to build competencies in domains such as banking, financial services, insurance, healthcare etc , and offer more value-added services to clients

Business in the BPO space may be affected partially, if there are adverse legislations passed against Indian companies based overseas One of the legislations passed recently in the US, may be a prelude to the ensuing damage in this sector.

Remuneration in IT-Enabled services

The salary differential is significant and one of the main contributing factors for foreign majors to set up base(s) in India While India as an offshore option continues to possess the best combination of manpower availability, scalability and lowest cost, productivity and quality of services are being increasingly looked at by Indian players who are trying to reposition themselves as a high value, high intellect nation rather than one focusing on cheap labor and low cost operations

Training in ITES

From the employee's point of view, psychological training focuses primarily on stress management and requisite on-the-job training for employees handling operations/transition and other key functions in the ITES space Training programs are to be designed to cover areas such as communication skills, teamwork, customer orientation, quality, time management

From the employer's point of view, acquiring the requisite domain knowledge and exposure to the style of functioning of global organizations are essential Other critical areas include employee retention policies (because of more players in the market), upgradation of technology to handle competition and increasing demand from clients

Beyond the US

Traditionally, nearly 65-70% of the Indian IT services exports have been to the US, that's a lot of eggs in one basket and the fall out was most keenly felt as that basket rocked in the last two years of the downturn. In the last two years, most companies have tried to change their US-to-the-rest of the world export ratio Corporates are increasingly looking at Canada, Japan, France, Germany, Italy (they account for around 27% of the global IT spend), for IT-enabled/BPO, as growth drivers for the industry

IT consulting

Tier I IT companies are considering taking on total IT outsourcing deals of major corporations From a revenue perspective, this means that the average size of a deal could increase from just $10 mn to as high as $100-200 mn The implications are obvious Not only would these deals grow India's share of the global software services market—from the sub 2% at present—but could also take at least a few Indian companies beyond the billion dollar revenue per annum mark However, to be perceived as a serious global player in the global IT outsourcing arena, Indian software companies need to have three crucial attributes Strong business consulting practice, high brand equity and a stable bank of talent. TCS, Infosys, Wipro, Satyam are few Indian companies pitching into the consulting bandwagon.

Conclusion

Indian IT industry is growing and the key factors which could contribute to the development in the IT industry are infrastructure improvement, reduction in bureaucratic set-ups, increasing investments in marketing, strong product focus, acquiring competencies in end-to-end consulting in specific domain segments Mergers and acquisitions can help companies in moving up the value chain. ■

The salary differential is significant and one of the main contributing factors for foreign majors to set up base(s) in India

Trends in IT

The Indian software and services industry's strong value proposition—low development costs, cheaper high-skill manpower and competitive billing—which had helped the country emerge as a key IT services outsourcing destination, continued to hold India in good stead during 2002-03.

KIRAN KARNIK
President
NASSCOM

The year 2002-03 was a mix of recessive global trends, with occasional signs of recovery. As the worldwide economy gave indications of limping back to some measure of normalcy during the second half of the year, the Indian ICT sector began to witness a gradual increase in momentum.

With soft quarters, pink slips, cost reductions and job cuts being the norm in most countries, it was encouraging to see the continuing resilience of the Indian ICT sector, which adapted well to the new context (even leveraged it, in fact). Interestingly, certain worldwide developments in the ICT market, which dampened IT industry growth in overseas geographies, actually aided India's cause. As a result, following the 29% growth in exports in 2001-02, the Indian IT software and services industry is poised to achieve a 30% growth this fiscal (ending March 31, 2003) year.

One of the most significant trends of 2002-03 was a major decline in overall IT spend in developed countries. As large global enterprises put a squeeze on their IT purchasing, cutting IT budgets and putting a cap on fresh IT infrastructure investments, many ICT solutions suppliers worldwide suffered revenue losses and witnessed major drops in overall growth. With companies becoming more conscious about optimally using existing IT infrastructure and focusing on issues such as Return on Investment, ICT vendors (who had geared up for the dotcom boom) were left holding vast inventories and low market cap. The worst affected were global telecom majors, who saw major dips in their revenues and a fall in their share prices during 2002-03.

The reduction in IT spending by overseas companies was accompanied by yet another development. Outsourcing. Eager to remain cost-effective and bottom-line aware, companies began outsourcing both their IS development (IT services) and IT-enabled services (ITES) activities. On the IT services side, the focus by customers moved to long-term strategic outsourcing, rather than outsourcing of small and short-to-medium-term software development projects.

In the area of ITES, companies began to outsource some of their non-core processes to organizations specializing in these areas. The reigning mantra became "focus on core competencies and outsource the rest." With outsourcing, these companies were not only able to cost-effectively manage some of their internal processes, but also were able to gain access to a vast pool of resources, that would have been impossible to develop in-house.

TRENDS IN IT

The rise in the value of the 'outsourced' business, especially to emerging and developing markets, greatly boosted the ICT industries of these service-providing countries India became a significant and major beneficiary of the outsourcing boom Well positioned as a player of substance in the IT services space, India also began entrenching itself on ITES/BPO turf.

The Indian software and services industry's strong value proposition—low development costs, cheaper high-skill manpower and competitive billing—which had helped the country emerge as a key IT services outsourcing destination, continued to hold India in good stead during 2002-03. These intrinsic strengths and advantages gave Indian IT software and services companies a leg up in the burgeoning ITES/BPO space as well, taking them beyond the realms of IT services

The ITES/BPO industry in India, in fact, has witnessed the highest growth over the past two years and is likely to maintain momentum over the next few years NASSCOM is convinced that this market will indeed live up to its expected goals and targets of achieving revenues of over US$20 bn and creating jobs for over 1 1 million Indian professionals, in 2008

The push given to the outsourcing market by the global customer community also created an interesting phenomenon for India. While industry experts were increasingly talking about reducing dependence on the North American region for Indian companies, and developing high-potential countries in Europe and Asia-Pacific in 2002, the reality proved to be rather different As US-based companies stepped up their IT services and ITES outsourcing activities, North America continued to be the largest market for India's software and services offerings The proportion of export revenues from Europe and Asia-Pacific failed to pick up significantly in 2002-03, contrary to industry expectations and forecasts Impacted by conditions prevailing in the US economy, Europe too slipped towards an economic slowdown and saw declining ICT revenues. The trend, however, is likely to reverse, once the economy picks up and Europe steps up its ICT activity Therefore, Indian companies certainly need to continue investing and addressing the European region for achieving long-term gains Marketing and brand-building both need a strong thrust, and have been somewhat neglected in the past India's triple advantage (productivity, quality, low-cost) needs to be marketed far more aggressively

While IT software and services exports stood up during 2002-03-maintaining growth in a tough and challenging environment—the domestic market chugged along at a slower pace Clearly, a lot more need to be done before the otherwise high-potential Indian market (coveted by MNCs and global ICT majors) can be converted into a significant business opportunity for the country's own IT industry

While improvements have been made in areas such as telecom and other infrastructure (power, roads, highways, etc) and though the policy environment appears conducive to software exports and IT investment activity, India is still lagging behind contemporaries such as China, the Philippines, Ireland, and other developed and developing nations on some very crucial parameters IT penetration, tele-density, Internet usage, local language IT applications—imperatives for the growth of the domestic ICT sector—are well below par These factors have in turn impacted the adoption of e-governance practices by the governments across India, despite some outstanding (but localized) projects With e-governance initiatives failing to proliferate at a rapid pace and most Indian citizens unable to enjoy the full benefits of IT, a digital divide has come up which is further expanding the

India became a significant and major beneficiary of the outsourcing boom. Well positioned as a player of substance in the IT services space, India also began entrenching itself on ITES/BPO turf

chasm between the haves and have-nots and the country's urban and rural populations. On the other hand, ICT has the potential to be the 'digital bridge', helping people to cross the rural-urban, rich-poor, educated-illiterate divides in our society

The key of hope however, is that all State Governments in the country have announced IT policies and initiated some kind of action on the e-governance front The long-awaited National Institute for SMART Government (NISG) is also on the verge of becoming operational, and should provide an impetus to e-governance

Indian industry too has been slow in adopting IT. Sectors where competition and deregulation are active (e.g , telecom and banking) have taken to IT, with resultant benefits to their efficiency and customer-service. However, many of the traditional sectors are yet to use IT as a productivity or customer-service tool With the opening up of more sectors and increased competition, it is likely that the use of IT by industry will see a substantial increase. Hopefully, 2003-04 will bring better news for India's home market and for initiatives that are targeted at actually improving the lives of the country's one billion citizens.

As noted earlier, the overall policy environment for the ICT industry continues to be positive and supportive. The Central Government and most of the States are proactive and facilitative in their approach to this sector. Changes in certain rules and regulations with regard to telecommunications, made at the instance of NASSCOM, have been of immense help to the ITES sector.

To help the IT industry, the government needs to improve the physical infrastructure (especially power and transportation), increase efficiency by cutting redtape, and upgrade the full education system

ICT, and the IT software and services sector in particular, is fast becoming a growth engine that can accelerate the development of our economy The very ambitious targets (an industry size of US$ 77 bn by 2008, with exports of over US$50 bn) are realizable, making India the software hub of the world This will not only enhance our economy and image, but will also give India extraordinary strategic maneuverability as the dominant player in a vital industry ■

Average Salary Across Different Experience Groups

	10 plus years	5 to 10 years	2 to 5 years	less than 2 years
Industry Average	32	9	5	3
DQ Top 10	34	8	5	3
DQ Top 5	42	9	5	3

All figures in Rs. Lakh Industry average 33 software companies from the HR survey DQ Top 10 or 5 are the 'common' companies that figure in both the DQ Top 20 and the HR survey

Employees in the Industry by Experience

10 Plus years	10.6%
5 to 10 years	23.3%
2 to 5 years	36.8%
Less than 2 years	29.4%

Base 33 Companies Source: IOC India

t's still a young industry—a good 30% of IT professionals n the country today are new entrants, with under 2 years of experience However, about 37% have been around for a while, with about 2-5 years in the business and some of them will be on the threshold of moving up from the executive to manager level. Not surprisingly, it's still not too heavy at the top, with only 10.6% of the industry consisting of professionals with over 10 years of experience

Source. DQ-IDC HR and Salary Survey; www dqindia.com

Career Opportunities in Outsourcing

The choice of India as an IT industry location is due to many important factors in India's favor—vast number of English-speaking, tech-savvy, and cost-effective workforce. No wonder that, with so much change in the economy and technology the job scene in the country in the last couple of years has witnessed a glaring shift.

SABYASACHI MISHRA
Associate Consultant
Intercon International Pvt. Ltd.
Secunderabad

The turn of the millennium marks a new age of information and unprecedented technological, commercial and social implications. Indian IT (Information Technology) Industry accounted for 15% of total export earnings in the last fiscal year and has recorded growth rate of 36%. The software industry alone currently employs an estimated 2,80,000 people in India. This is expected to grow to 2 2 million by 2008 No doubt, job scenario has also witnessed the wind of change and with this IT has become the most wanted option The key elements of growth are off-shoring, which will lead to the 10-fold growth of the jobs in India. It will be rather called a "*Desi* Boom" Off-shoring has become very cost-effective for almost all the companies who have their presence

On the threshold of new millennium, the job scenario is in the transitory stage, as most other things Glaring shift can be seen in the preferences of youth from conventional areas of career options to vista of new employment avenues due to recent development in technology This shift, broadly, is the outcome of decade-long changes in Indian economy and technology.

ERP, computer animation, data warehousing, system analyst and design, Internet, e-commerce, networking, more recent WAP (Wireless Application Protocol) and embedded technology are the other areas where job opportunities are enormous Besides availability of jobs, the industry offers employment to people of diverse personal qualities, obviously, knowledge of technology is necessary for anyone of these jobs, there exists the choice to go into high-tech jobs such as advanced computing where technical expert make programs in assembly language and also depending on subject of interest, one could work on weather forecasting, fluid dynamics, biological studies and the like. Jobs requiring creative skills, such as Web designing or computer animation, networking, software programming is some of the other openings.

Business Process Outsourcing

BPO is an integral part of every organization as of today. Non-technical jobs like enabled services such as, medical transcription, call centers, data processing

are some of the booming businesses in recent times and have been creating huge employment opportunities Minimum qualification of 10+2 and good command over English are the basic things needed to fit in these enabled services The employment base of call center business alone is expected to touch 2 5 million by the year 2007-08 In these new areas of Medical Transcription etc , you can earn just after your school and, the best thing is, in a short span of time

The Indians have also practised to match the US timings to support customers India would soon become an ITES HUB for almost all the companies abroad The choice of India as an IT industry location is due to many important factors in India's favor—vast number of English-speaking, tech-savvy, and cost-effective workforce as well No wonder that, with so much change in the economy and technology the job scene in the country in the last couple of years has witnessed a glaring shift

Other countries like Ireland, Canada, Australia NewZealand and Philippines have BPO's but India is the dream destination of all the companies today for their BPO set-up because of good adaptability in terms of command over english, cost and quality India would experience the BOOM # 2 i e ITES/BPO

Remuneration wise the ITES Jobs fetch much lesser than foreign Markets. A Customer Service associate in USA makes a good $30 000 — $40,000 per annum whereas a counterpart Indian makes a modest Rs 1,20,000 per annum which is just more than $2,000

The Indians have also practised to match the US timings to support customers. India would soon become an ITES HUB for almost all the companies abroad

Training requirements in ITES

Apart from client-specific product and services training, specialized training is given in the areas of collections, mortgage origination, consumer and auto finance, credit card support, banking, finance and accounting support The industry training provided typically includes elements about legal and regulatory structures in the client country, specific industry jargon that is used in those nations, and of course, additional voice, accent and cultural training For the first six months the specialists have to further refine their knowledge for understanding the support requirements better in the international call center/BPO environment The company also has a buddy system in which experienced agents are made to work with new recruits, to facilitate and accelerate the learning process

New entrants have to go through a three-pronged systematic training program to improve their skill sets and get a good grounding in the organization's philosophy and value system They go through voice and accent data training session for cultural orientation, accent neutralization, pronunciation, and vocabulary and voice modulation. The new recruits are also given a thorough training in actual floor working and functional area of work like product and systems training Other training issues are need based and depend on customer requirement

Few of the ITES Companies have also tied up with training giants like Aptech for training on specialized subjects like banking, accounting, sales and marketing

We are in the recruiting business since the last 25 years and are the recruiting partners of some of the leading companies in the World· Deloitte Consulting (A Big Five Management Consulting Firm), IglobalMedia (E-Gaming Giant), Spectramind, and CallWorld Technologies

Normally ITES jobs attracts freshers As a recruitment firm we nurture them with the key elements of the Job—understanding the job profile, adaptability to the corporate world and focus match Briefly the candidate needs to understand BPO overview, company background, growth path, interview skills and maturity levels needed for the job ■

E-Recruitment Changing Scenario

The biggest advantage to several companies which outsource operations to India is inexpensive and high quality manpower, especially in the IT-enabled services sector. Apart from this, many IT companies are relocating their development centers in India. This trend is likely to continue in the foreseeable future.

SANJEEV BIKHCHANDANI
CEO
Naukri com

The e-recruitment space in India is growing fast although it lags behind in the West While current online recruitment accounts for only 2-3% of the market, a Forrester Report released in 2002 predicted that online recruitment will account for 80% of this space, by 2008 We have, at naukri.com, just witnessed and been part of this growth—we have had exponential revenue growth over the last three years Our sales grew from Rs 92 lakh (1999-2000) to Rs. 3 8 cr (2001-2002) last year and we are on target to achieve Rs 10 cr, this year (2002-2003)

Logically, one would expect that the economic downturn would have had a negative impact on the e-recruitment space. On the contrary, it has had a positive impact—as budgets have been cut, more and more companies have had to resort to systems that are more efficient and less taxing on man-hours Moreover, there are two factors, which determine whether a company will use e-recruitment—both of these have been on the up, in India, over the last 4-5 years

a Degree to which a company is e-enabled and the level to which they have Net connectivity and

b The comfort levels of their employees to use e-tools and how Net savvy they are

We offer three basic types of services

- Job Listing Services
- Response Management Software—e-Applications through which recruiters can manage responses collected to advertised vacancies and reduce time spent on handling applications by over 80%
- Résumé Database Access—RESDEX, through which we grant access of our registered CVs to corporate clients/ placement consultants for a fee in order to facilitate the headhunting process
- In addition, we even provide additional services such as organizing walk-in interviews, résumé short-listing, and conducting first-cut interviews, to some of our longer clients.

Present market scenario

The job market is a lot better than it was a year ago The worst of the downsizing is over (barring an event risk such as a Gulf War) IT is bouncing back, however it will never be like it was three years ago ITES is booming Even in manufacturing, we expect a revival in six to nine months

Telecom, insurance/financial services and IT-enabled services sector, pharma and health care have seen a spurt in recruitment Many of these are new sectors so it would be difficult to refer to this trend as a revival

Outsourcing in India

The biggest advantage to several companies which outsource operations to India is inexpensive, high quality manpower especially in the IT-enabled services sector. Apart from this, many IT companies are relocating their development centers in India.

This trend is likely to continue in the foreseeable future. What is more important is that these facilities are being set up to do high-end work. India is finally migrating up the value chain in IT although Indian companies may not be as these development centers belong to US companies.

India does offer a much cheaper labor base. While salaries have certainly improved over the last 5-7 years, we are far from being on an equal footing with salaries in the West. Even in the future, I do not see comparable salaries—and where this is the case, it would be an exception rather than a rule. But an advantage due to cheap labor alone is not sustainable. India has to migrate up the value chain and sell on attributes other than price—quality, reliability and the ability to handle complex assignments. The first signs of this happening are already coming in ■

Online Recruiting Gaining Momentum

When it comes to outsourcing of manpower, it has always been a transition. Initially it was Ireland, where MNCs used to outsource their work for call centers. After Ireland's manpower became costlier due to demand, India emerged as the next option for MNCs.

ARIJIT SARKER
Manager – Marketing and Customer Care
Jobstreet.com India Pvt. Ltd.
Bangalore

It is rightly said that online recruiting is gaining momentum the world over When it comes to India, it has tremendous potential in the years to come This is evident from the increase in the number of jobs being posted in our site and also the number of job seekers registering with us, month after month.

Indian recruiters, both corporate and recruitment firms are catching up fast with this mode of recruitment, due to its obvious benefits like speed of recruitment and cost-effectiveness.

According to Forester Research in US, 50% of the total recruitments are through online recruitments. According to our estimates by 2005, it is estimated that 65% of the total recruitments will happen online and the other form of recruitments, only 35%.

There are various other services that are provided by online recruiters apart from Job Listings, like Résumé Data Bank Search, Job Alerts

Job Listings are like online advertisements and when a job seeker visits the site and browses the jobs section, he finds all the jobs available. He can apply for the appropriate job.

Résumé Data Bank Search enables the corporate to search all the résumés of job seekers in our database. Thus, if a corporate finds suitable résumés for his requirements, he will call these job seekers for an interview

Job Alerts are those that are sent to job seekers as e-mails, which contain suitable openings in their industry or which suits their profiles. So, even if the job seeker is not actively looking for a change or misses some job posting of relevance, he will get this alert.

Present market scenario

Junior executives (2-5 years) account for the highest number of job shifts and the jobs available for these positions are much higher when compared to senior executives and managerial positions Senior executives (5-8 years), managers (8-12 years) and senior managers (12 and above) follow in terms of the jobs available and job shifts, in that particular order

However, in the last quarter of 2002 and first quarter of 2003, we saw a slight increase in the percent of job seekers, in the junior executives level.

ONLINE RECRUITING – GAINING MOMENTUM

Specialized areas in boom

According to our Recruitment Trends Analysis for the last quarter of 2002, we observed that the software, health care and medical, telecom and automotive areas are in a boom and there are lots of jobs being created in these areas The percentage increase in the number of jobs in the last quarter of 2002 when compared to third quarter in 2002 is Software – 25 06%, Telecom – 18 27%, Automotive – 14%, Health Care and Medical - 12.31% This shows that the economy is in a slow recovery mode when compared to how it was in 2001

Favorable factors that attract big MNCs to India

We observed that the following factors are attracting MNCs to India

- Large English-speaking talent pool
- Manpower cost being low
- Good quality of education leading to a sizeable intellectual pool
- Improved infrastructure and Government's policies

When it comes to outsourcing of manpower, it has always been a transition. Initially, it was Ireland where MNCs used to outsource their work for call centers After Ireland's manpower became costlier due to demand, India emerged as the next destination for MNCs

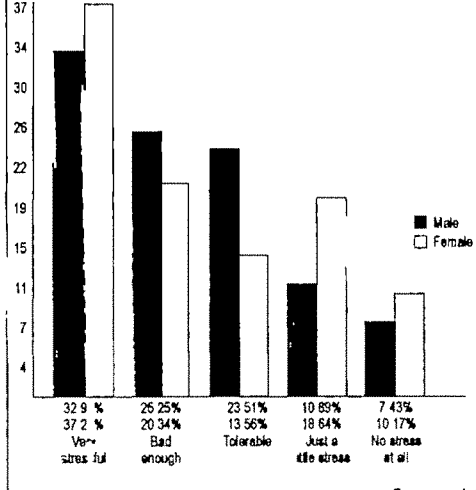
This phenomenon depends on the demand/supply mechanism When India becomes self-sufficient and when the supply of manpower is lesser than the demand, it is bound to become costlier Then, MNCs will look for a cheaper alternative Probably China, with its increasing English-speaking population will become an alternative

Whatever said and done about e-recruitment, one should agree that it is still in a nascent stage and what the e-recruitment companies have tasted, is only a tip of the iceberg Lot of progress is to be made and we at Jobstreet com feel that the industry is moving in the right direction

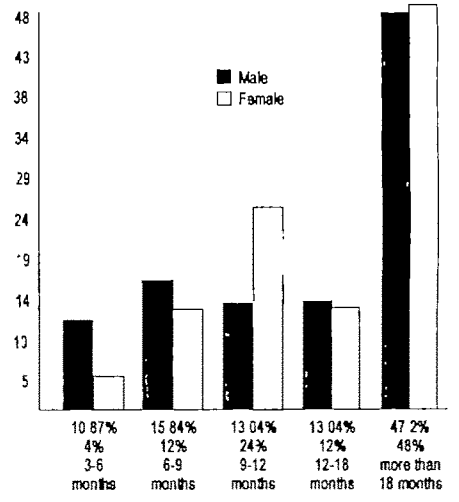
The industry will witness a great deal of improvements and enhancements in the time to come. The key factors being

- Information (users want more and more information about the companies and vice-versa, about their application status etc)
- Accountability (both for the corporate and job seeker and both are responsible for their actions)
- Technology (like integration of hand phone with Internet, computer penetration etc) ■

How stressful is your job in the wake of the present worldwide economic slowdown? (1 – 2002)



How long will it take the Indian economy to recover? (9 – 2002)



Source Jobstreet com

List of Prominent Placement Consultants in India

Bangalore		
Name	**E-mail**	**Website**
Alp Management Consultants Pvt. Ltd	info@alpconsultants com	www alpconsultants com
Oxford Consultants Pvt. Ltd.	info@oxforddcpl com	www oxforddcpl com
Sampoorna Computer People	bang@sampoorna com	www.sampoorna com
A B C Consultants Pvt Ltd	bangalore@karmaquest.com	www karmaquest com
A F Ferguson & Associates	affmc@vsnl.com	www.afferguson com
Datamatics Staffing Services	dssblr@vsnl com	www datamaticsstaffing.com
Ernest &Young Pvt Ltd	NA	www.eyindia.com
Hewitt Associates (p) Ltd.	NA	www.hewitt com
Inter-Management Manpower Services Ltd.	interblr@intermanagement.com	www intermanagement.com
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GERMAN ECONOMY

Revival dilemma

The German economy is stalled in deep problems. If it does not turnaround, the risk of going the Japan way with high unemployment and deflation looks inevitable.

Germany, the third largest economy of the world after United States and Japan, and one of the growth engines for the European Union, has posted one of the dismissal economic performances. The poor performance of big economies is raising doubts about the future of global economy. With US economy showing mild signs of recovery and Japanese economy continuing in doldrums, Germany's economic performance was the most sought after. However, with a poor growth of 0.2%, German economy showed up one of the worst performances since the 1990s. Even, the current year projections made by both government and other industry bodies indicate yet another poor show. In fact, the German government was forced to lower its growth targets from 1.5 to 0.7% for the current fiscal. This is only an indication of the plight of the German economy in the coming years. Also the decline of Dax by over 40% from its peak is a contributing factor to the country's stagnant economy.

German economy, which has grown by leaps and bounds after World War II, is for the first time undergoing a lean phase. The hidden causes for the bad state are surfacing now. But what are the critical factors that have forced the German economy onto the verge of recession? How can the issue be tackled? What are the various options available for the government to kick-start the economy? And finally, considering all the challenges, can the economic engine be restarted?

Problems galore

"In bad times, all problems come together,"—perhaps this is what is happening in the case of Germany. For the German Chancellor, Gerhard Schröder, dealing with multiple tasks on different platforms has become the norm of the day. Obviously, on the priority list, is economic growth. But many economists feel that the economic growth of Germany will remain sluggish in the coming year. Bob Hancké, Lecturer in European Political Economy, European Institute, London School of Economics and Political Science, feels, "I expect German growth to be very low—domestic demand is low, and low growth in France and Italy is insufficient to raise German exports. Also, uncertainties about a war with Iraq may mean that the euro-dollar exchange rate remains unfavorable for Germany for a while, so there is little alleviation to be expected from that side." Echoing a similar viewpoint and hinting at a possible German recession, Adrian Ottnad a contributing Senior Economist, Bonn Institute for Economic and Social Research, says, "Presently the German economy is very close to recession. In 2003 the annual growth rate of real GDP might not exceed 0.5%. Even stagnation cannot be excluded. Recovery should not be expected before the second half of the year. How fast this recovery will proceed depends on the political development in the Middle East and on the political efforts to reform Germany. This means that there is a relative wide range of possible growth paths in 2004 (between 1 and 2.5%)."

Explaining some of the broad factors that had a profound impact on the economy, Simeon Mitropolitski, Reviewer, *International Real Estate Digest*, (www.ired.com), says, "The German economic growth in 2003 will be close to 0% due to many internal and external factors. Among the internal factors I'd like to mention the higher taxes compared with some other countries of the Euro-zone. Among the external, which have major effects on the internal consumption, there could be mentioned the higher energy prices due to the Middle East crisis and the strike in Venezuela."

The poor economic growth can be attributed to internal reasons mostly. The ruling coalition of Social Democrats led by Chancellor

"Reforms like the ongoing liberalization of markets and enlargement of the EU into the east and proximity to those markets will enhance the growth performance of German economy."

Dr. Ulrich Martens-Jeebe, Director, Office of the Federal Commissioner for Foreign Investment in Germany, Berlin.

Q Or growth of German economy.

German growth perspectives are highly dependent on external factors. These are currently influenced by an unpleasant degree of uncertainty—mainly owed to global security issues. This geopolitical situation affects the international demand for German export goods which has always been the growth-engine of German economy. To a certain extent, some monetary issues will play a—minor role as well. Germany is part of the Euro-zone such that monetary policy decisions of the ECB will have their impact on German economy but are not to be exaggerated. Finally, the terms of trade, to a very large extent, the development of oil prices, will likewise have an impact on the well-being of German economy. If these factors will develop in a pleasant way, economic growth in Germany—like every other economy in the world—will quickly gather momentum.

Q On major factors.

It owes much to the fact that German economy in the previous year was not been able to benefit from its objective advantages like geography, market size or infrastructure, due to the generally lower level of investment in the international economy. In times of a global reluctance to invest, internationally exposed economies like the German are particularly harmed by this general sentiment. Additionally, it demands much more effort to speed up growth in a very large and mature economy like German economy compared to most of the considerably smaller economies in the European Union.

Q Factors that will propel the economic growth in future.

The further development of knowledge-based industries like biotechnology or Life Sciences. The expected growth in the ICT-branches and the continuing success of the 'Made in Germany' brand in the export sector. Additionally, some reforms like the ongoing

Gerhard Schroder and the Greens was not able to push through with much needed economic and labor reforms. Schroder seemed to be more adept at pleasing the strong labor unions than fixing the plethora of problems facing German businesses. The level of unemployment at 9.7% of the workforce coupled with liberal benefits for the unemployed increased the burden on the state finances, put pressure on the budget and in turn aggravated the country's economic problems. Ottnad further adds, "Germany is still suffering the burden of the reunification process. Unemployment rate in East Germany is more than twice as high as in West Germany. There is net capital flow of about €100 bn from West to East each year. Furthermore, in the early 1990s financial transfers and subsidies caused an overshooting boom in the East German construction industry. This boom was followed by a massive decline of the construction industry lasting from 1995 until now."

Withholding the internal problems, Germany is also under tremendous pressure from the European Central Bank (ECB) to curb its fiscal deficits. According to the Growth and Stability Pact signed by the member states of the European Union, no country is allowed to maintain more than 3% fiscal deficits. Owing to excessive spending by the government to propel its economy, Germany has surpassed the stipulated limit and in all probability will invite hefty fine from ECB. Currently the fiscal deficit of Germany stands at around 3.75%. Though the government has been saying that it will initiate measures to bring down the budget deficits, the condition of the economy may not allow it do that. To bring down deficits, the government has to increase taxes and cut down investments. However, if these measures are adopted then the chances of reviving the economy become bleak. Generally, during recession, taxes will be lowered and further investments will be done to give a boost to the economy. Perhaps, Germany is caught between the deep sea and the devil.

Although the present economic slowdown is partially caused by cyclical factors there is no room for the German Government to stimulate the domestic demand by increasing its deficit furthermore. Ottnad feels, "The government has failed to bring down structural deficits in the past years. Even worse, misled by much too optimistic growth expectations, government did not finance tax cut in 2000 by reducing its outlays, thus increasing structural deficits again. In 2002 Germany violated both the so-called 'Maastricht' criteria limiting deficit to 3 and debt to 60% of GDP." The real danger is that the present situation may undermine one of the strong pillars of the European Stability and Growth Pact. Ironically, this has been the major condition put forth by Germany to join the European Union. Recent developments in the global political scenario, however, may work in favor of Germany.

liberalization of markets and enlargement of the EU into the east and proximity to those markets will enhance the growth performance of German economy

O On viable options for German Government.

The German Government is well advised to pursue some policy action with regard to tax and the labor system, particularly to reduce cost of employment. Furthermore the tackling of corporate governance issues to restore shareholders' confidence will be likewise helpful. The German Government is already on right track when you look at past efforts to strengthen consumer protection and further liberalization of sectors just to mention a few on the reform agenda. I do believe that stronger efforts to attract further foreign investment by means of marketing is an important policy option as well. Likewise, the increasingly open stance toward new technologies, most notably in the biotech sector, will prop up the investment propensity in German economy.

O On interest rates.

For the time being nobody is able to predict how long the performance of the international economy will be affected by political issues. At the moment we observe a great willingness in German politics to cope with the problems mentioned above by counteractive measures aiming at tax and labor market issues. With regard to the Euro-zone I do not believe that interest rates are at the moment a major obstacle to investment—at least in Germany which has over decades pursued a policy of tight money and favorec a strong Deutsche Mark—at the same time Germany has been undoubtedly a successful economy.

O On political will towards reforms implementation.

We have embarked on a new situation since a few months. The current public discussion about necessity of reforms puts much more pressure on policy makers compared to previous times. Politicians in turn have indicated their willingness to tackle a more comprehensive reform agenda. Please do not forget that Germany has implemented since 2000 a far reaching tax reform and is a European pacesetter with regard to liberalization of markets like energy, transport or telecommunication which are still state monopolies in other European countries.

O On importance of Germany to EU.

Germany is the largest economy in the EU with about 25% of total EU output and a consumer market which makes up about 22% of the EU-population. It is the most internationally integrated economy in Europe which hosts the most important global players that are located in Europe from overseas. Finally, the countries of the EU are the major trading partners for Germany such that any chance in the well-being of the German economy will have immediate repercussions on European economies.

Reports indicate that Germany may cite the 'Exceptional Clause' in the Stability and Growth Pact, which can suspend the criteria, thus avoiding hefty fines and clearing the roadblocks in increasing deficit spending to spur the economy. But all this can happen only if the war in the Gulf region prolongs for a considerable period of time and of course, the final decision in this regard will be made by the ECB.

One of the major problems that Germany is facing today is with regard to the employment situation. The unemployment rate has reached a double-digit and the need of the hour is to reform the rigid labor laws. The high unemployment rate has crippled the economy as it had badly hit the demand side. Ottnad supports this argument when he says, "The massive hikes of taxes and contributions unforeseen by most consumers and investors weakened the domestic demand within the last few months. Probably this effect will still work for the next few months as there is a lot of uncertainty within the markets, investors and consumers and they are hesitant to spend their money." The high tax burdens and levies and the lack of incentives in social welfare systems has resulted in a sluggish growth. Considering the political situation, it requires more than reforms to reduce the unemployment rates—as it requires striking a right balance between the companies and trade unions. Ottnad explains, "Labor unions successfully prevented the social-democratic led government from necessary cuts within the social security system and from labor market deregulation. Meanwhile economic, budgetary and unemployment problems have escalated." Though the government has set great hopes on the recommendations of the Hartz Commission, the common feeling is that the proposals will only touch the surface of the unemployment problem without tackling the root cause. And as direct fallout of these aspects, there is a problem of looming pension crisis. Ageing population is posing a serious challenge for the country's social security system and it is believed that German Government has to shell out more funds to meet the demands of ageing population.

In spite of early indications, Germany has not pushed the much-

> **The key to an economic recovery in Germany is a credible and sustainable reform strategy. With respect to the decline of investment and private consumption within the last two years there is enough potential demand to support an upswing.**
>
> **Adrian Ottnad**
> *Senior Economist, Bonn Institute for Economic and Social Research*

needed structural reforms. If one analyzes the economic growth trends of Germany in the 1990s, it can be easily identified that the real problem started somewhere in 1995. From then on the economic engine moved very slowly. At that point of time, reforms were proposed and only a handful of them were implemented. However owing to political considerations and floods, the ruling coalition government withheld most of the reforms. Commenting on the reforms commitment, Simeon says, "The lack of will from the German Government to make structural reforms that will go against the interests of the left electorate, which has brought twice this coalition to power, is in addition to the other factors that have hampered the economic growth. Germany lacks economic dynamics due to highly bureaucratized social structures." However, Hancké hints at aspects that are required more than reforms, when he says, "The attention devoted to complaints about the 'structural rigidities' in the German economy is entirely unwarranted—if Germany were stuck in a poor microeconomic model, why does it perform so well in export markets? The central issue is whether Germany (or any other country for that matter) truly needs the textbook reforms everyone talks about."

One area that seems to be vulnerable to the developments in the economy is the banking sector. Sinking fears were expressed about the banking sector. Apart from the economic woes, German banks have over the years manifested their own problems, which now together with recession can prove as a final nail on the coffin. According to experts there are three main reasons for the banking sector to be in a mess. The first one being the state of the economy, which has forced many companies to bankruptcy. In addition to the above, the fall in stock market has taken its toll on the banking sector's net holdings values. These economic factors influenced the earnings of banking system. And when stock markets were going through a bull phase, most banks had funds in investment banking. However, only a few were able to gain from the foray. But, if recovery is on its way and German banks can adopt measures to slash costs and reorient their businesses, the loss from investment banking can be minimal. However, the fragmented structure of domestic banking market may hinder the recovery of banking system. In that case, the economic problems of Germany will further complicate.

Perhaps, the only thing that still seems to work in favor of Germany is the growth in exports, which is stabilizing the economy to an extent. However, economists feel that exports can no longer sustain the momentum as the situation remains the same in US (considered as the second home market), Italy and France. Also, the appreciation of euro can have its impact on exports. It is feared that the cost of German goods will appreciate along with appreciation of euro and thus reduce the overall exports. While the appreciation of euro is good news for the EU, it can turn out to be a bad news for German exporters in the coming days.

Way out

Considering the bigger gambit of problems, the road ahead for the German economy is certainly not easy. Tackling problems right from employment to containing deficits, Germany has to rely extensively on some external factors and to a large extent on the internal factors. Simeon opines, "I suppose the German Government will again rely on the US recovery and to some extent at the EU enlargement to feed up the demand for the German industrial products. In long run the economic growth in Germany may be supported to be a combination of many factors: Lowering taxes, liberalizing the labor market and stimulating the high-skilled and low-skilled mass immigration." However, the recovery of US depends much on the outcome of developments in the Gulf Region. In case, war breaks out, then recovery of US economy may be prolonged and that can impact the German economy substantially. Hancké opines, "A more expansive macroeconomic regime, including an ECB that lifts growth expectations and a fiscal policy which is not constrained by the Stability and Growth Pact—under these conditions, supply-side (especially labor market) reforms might contribute to falling unemployment. However, I am highly skeptical of the ability of supply-side reforms alone to raise growth in Germany: Businesses do not invest if they do not have stable growth expectations."

> **"I am highly skeptical of the ability of supply-side reforms alone to raise growth in Germany: Businesses do not invest if they do not have stable growth expectations."**
>
> **Bob Hancké**
> *Lecturer in European Political Economy, European Institute London School of Economics and Political Science*

On the contrary, Ottnad feels that structural reforms can solve most of the problems for Germany when he says, "The key to an economic recovery in Germany is a credible and sustainable reform strategy. With respect to the decline of investment and private consumption within the last two years there is enough potential demand to support an upswing." One of the strong suggestions that is emerging is the need to reform the labor laws. Corporate bodies in Germany feel that if labor reforms are carried, it can improve employment situation and thereby enhancing the purchasing power of

citizens. This in turn is believed to spurt demand for manufactured goods—a boost to economic growth.

The question that is being pondered by one and all is whether Germany is heading towards a recession? Economists have forecasted that risks of recession are higher as there is no hope for a near term domestic recovery. Hancké agrees with the economists when he says, "We are currently caught in a situation which might lead to deflation in the Euro-zone. In fact, the ECB has admitted as much in the autumn of 2002, when it said it would revise its inflation target." Adding a new dimension, Simeon, says, "The anti-US position held by Germany in UN could jeopardize the relations between Berlin and Washington, both political and economic. The German economy is dependant highly on exports so any major fluctuation on the international arena could have disastrous and immediate effects on it." In fact, according to many business houses the business ties will deteriorate further between US and Germany as a result of the rift over Iraq. Until and unless the German Government initiates strong measures, risk of recession would loom large.

Impact on EU

Being one of the biggest economies in the European Union, the problems of Germany can have its repercussions on the growth of EU. This is true especially when other economies like France and Italy are confronting similar problems not though on a similar magnitude. Ottnad explains, "Germany is by far the biggest economy within the EU contributing to one quarter to the GDP of EU and one-third to the GDP of EMU. Therefore, Germany's economic weakness (together with France's similar problems) has serious impacts to the growth in the EU." Adding further, Simeon, says, "Given the fact that Germany represents one-third of EU economy and the geographic positions of the country in EU, its importance is determinant for the economic well-being of Western Europe and beyond. There could be no real growth in Europe without German participation. That's one of the main economic lessons in Europe after World War II."

Since the German economy is exposed to the danger of recession, there is a mixed feeling among EU member states, that repercussions will be felt on their respective economies as well. If the tentacles of German economic problems spread among the member states, then perhaps we might be witnessing another experience that will be similar to the one that was felt at Latin America recently. However, the ECB is aware of the possible impact and in fact trying to maintain the interest rates higher than the US interest rates in an attempt to improve the German economy. Of immediate concern for the ECB will be the growing budget deficits of Germany, France and Italy. Since Germany is a big economy in EU, the deficits can have a profound impact on the Growth and Stability Pact of EU. At the same time, it can also create overdistribution of funds between ECB and other member states within EU. Opines Ottnad, "Besides the budgetary problems of Germany, being the biggest net-payer in the EU, so far, the problems can increase distribution conflicts within the EU."

No doubt, German economy is a key component of EU economic growth. Hancké, offers a different perspective when he says, "Germany is crucial for the entire EU/EMU for two reasons. One, its wage rate is de facto the wage rate for all of Europe. Second, Germany trades a lot with the rest of the EU/EMU (hence the linking of wages to German wages), which implies that if growth is low in Germany, it depresses aggregate demand in the rest of the EU/EMU." Explaining the logic behind the correlation of German and EU, Hancké says, "German wage-setters have been trying to gain back some of the ground they lost after the above-EU average inflation rates due to unification in 1990-91, and the realignment of the EMS in 1992-93—this may have reduced German competitiveness by as much as 25%. Lower wage settlements than in the other EU countries since 1995 have allowed Germany to regain some of that ground. The problem is that—controlling for unemployment, which is lower in smaller European economies—wages in other countries are increasingly set as a function of German wages. The effect is that there is only little room left for a wage correction in Germany."

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>
> **Simeon Mitropolitski**
> *Reviewer*
> International Real Estate Digest
> *(www.ired.com)*

Since the correlation between Germany and other member states of the EU is high, any signs of recession will have a profound impact on the entire EU. At the same time, a recovery in the German economy in the near future—though a distant dream—will propel the growth of EU. While there is a general agreement that such effects cannot be calculated, the recovery of German economy is vital not only for EU but also for the global economy.

Y Chandra Sekhar

Reference # 1-2003-04-07

THERMAX'S TURNAROUND

Regaining focus

The turnaround at Thermax was a matter of fixing deep-seated problems, such as the directionless diversification, board scuffles and bloating costs.

In the late 1990s, Thermax was struggling because of a slowdown in the capital equipment sector that was steadily affecting its profits. From a Rs. 45 cr high in 1998, Thermax's net profit dipped to Rs. 32 cr in 2000 and then to a loss of Rs. 13 cr, the year after. Besides, the company's unyielding diversifications and board scuffles only added to the problem by bloating costs and delaying a response to the changing environment.

Things have improved since then. Thermax has made a profit of Rs. 24 cr in the year ending March 2002 and is expecting a 10-15% topline growth in the current year. Last year, it managed to turnaround its chiller business, substantially improved topline and bottom line in its chemical business, bagged a Rs. 90 cr contract for its co-generation group, and even earned $10 mn in revenue from international operations. It has also reconstituted the board exited non-core business restructured and regrouped businesses along with cutting costs while emphasizing exports and services.

Getting the act together

While conventional wisdom says that diversification is the best way to minimize risks, the same became a bane for Thermax, because the diversification it undertook was directionless: It was not backed by able leadership to face the hostile external environment. As a result, the company was mired in organizational and management problems—it diversified into several businesses and markets, and the investments in most of them weren't paying-off. Then again, the material and operational costs of the company were weighing heavy on its bottom line. In fact, most of the company's problems can be attributed to the fact that it was rendered directionless after the death of its illustrious founder, R D Aga. Urmik Chayya of Karvy Stock Broking Ltd., cites the following reasons for Thermax's decline: "First, the domestic scenario, small engineering companies were squeezed. Second, Thermax had focused on South-East Asian market for exports and almost immediately that market collapsed. Third, the management, post-Aga, completely lost focus." Indeed, Aga, an entrepreneur and management thinker led Thermax from a small boiler company to a multidivisional major with a focused vision and mission to conserve energy and preserve environment, and after his death in 1996 the company was caught up in uncertainty just as the business environment became adverse. Harshvardhan Dole of Dalal & Broacha reflects similar views. He says, "The company had been struggling for past few years mainly due to an unfavorable external environment for its core areas. This was further magnified by the lack of a coherent business philosophy and an unwieldy structure."

However, with the help of the Boston Consulting Group, the company was able to find its way through uncertainty and renew its focus onto its core strengths. Under its present Chairperson Anu Aga and the Managing Director Prakash Kulkarni (who assumed office in July 2000), the company has successfully completed the two phases of the turnaround. Phase one involved short-term strategy of buoying up the bottom line, followed by phase two that addressed the topline issue of growth. As part of the first phase, the company tackled the three crippling problems: 1) Diversification, which was giving no returns, 2) Board problems that hampered decision-making and 3) Costs, which were affecting profits.

Core at the fore

Thermax had diversified into too many yet too varied businesses. Its diversifications took it into bottled water, software, lease financing—in effect anything that caught its eye. In the process, it forgot its core strength in boilers and chillers. Even though it formed alliances for most of its diversifications, because it lacked knowledge of these businesses, the investments weren't yielding returns. So, as part of the turnaround, the company refocused on its core business and accordingly, Thermax exited most of the peripheral businesses such as transmitters (a joint venture with Fuji Electric), electronic components, software, bottled water (a joint venture with Culligan), lease financing, fans, and the painting systems of the surface coatings subsidiary. A buyer is now being scouted for the industrial washing machines business. As a result, Thermax is now a leaner, more efficient company with its core businesses of boilers, chillers, cogeneration and captive power systems, pollution control systems and special chemicals.

Furthermore, the company went ahead with a business restructuring exercise which resulted in re-grouping of all its businesses under five heads to achieve distinct synergies and

focus, as well as to break the vertical silos in which the businesses had been operating. The company now, through all these streamlining efforts, hopes to exploit cross-selling opportunities and provide integrated solutions to clients like pharma and oil extraction plants, which use traditional Thermax products such as boilers, chillers, water treatment solutions and chemicals. To encourage cross-selling further, the dealer network consisting of 80 dealers spread across the country is revamped, which will in turn increase the reach and improve dealer training and customer interface.

'Chill'ing the Board

The next milestone in the turnaround process was to rectify board problems. Earlier executive directors predominated the board, leading to conflicts of interest and delay in decision-making. But now, the board has been reconstituted, as per the Boston Consulting Group's suggestions, with non-executive directors who would lend an impartial view to the company's operations.

The deeper problems with the culture of the company were addressed through some major changes. The board was separated from operational management while developing a structure to deliver sustainable solutions and developing management depth. The board was made more accountable by reducing the number of working directors, and increasing the number of independent directors.

The new board is an eight-member team, with the MD, Prakash Kulkarni as the only working director as against the earlier norm of eight working directors among the 13 directors who constituted the board. Now the smaller, more efficient board has three promoter directors, four independent directors selected from a spectrum of industries.

So far as building management depth is concerned the company formed an executive council with heads of businesses as its members. This eight-member council operates like an internal board, on the lines of the management council at Hindustan Lever. All this quickened the decision-making process and eliminated procedural delays and hitches.

Killing costs

The phase one of the turnaround process also embarked on a cost-cutting drive just as organizational and management problems were set right. Global sourcing to reduce material costs, streamlining of the supply chain and shrinking the design-to-market cycle time, were part of the cost-cutting activities. As a consequence of that, already 5 to 7% reduction in material costs has been achieved. Quality improvements, which contribute to fewer replacements, and better project management, brought down costs further. While greater focus on quality brings savings in terms of reduced warranty expenses, streamlining of the supply chain and improved productivity contributed to profitability. The Dalal and Broacha report on Thermax says, "In FY02 the company decided to go for centralization of its purchases by various divisions. This has resulted in enhanced bargaining power and substantial reduction in cost. As a consequence raw material cost as a percentage of revenue has come down to 53% from the previous year's 56%. The full benefit of this was not felt as the process was not in place for the full fiscal, and further benefits would be visible from FY03 onwards."

The company followed the tried and tested formula (and the foremost one) in a turnaround attempt—laying off employees to cut down on employee costs. Thermax downsized or rather (as it calls its lay-off efforts) right-sized, by introducing a VRS offer to its white-collar employees. Some of the employees were fired for non-performance. Many more job eliminations resulted because of loaded businesses. As a result, the total number of employees came down from 2,000 to 1,200. The downsizing efforts were reflected in the shrinking of employee cost from Rs. 64.75 cr in 2000-01 to Rs. 61.35 cr in 2001-02, making up 13% of the turnover as against 16% of the turnover in 2000-01. Lately, the company is exploring the possibility of offering VRS to shop floor workmen considered surplus after the streamlining and integration of operations.

Exports and service: Awesome twosome

After putting the bottom line on track by managing costs and

Segmental Snapshot (in %)

% contribution to revenues	2QFY03	1HFY03	FY02
Energy	67 7	69.3	61.2
Environment	32.3	30.7	38 8
% contribution to PBIT			
Energy	68.4	63.6	49.0
Environment	31.6	36 4	51.0
PBIT earned per segment			
Energy	9.1	6.9	8 4
Environment	8 8	8 9	13.8

Source: www equitymaster.com

Cost Break-up (Rs mn)

	2QFY02	2QFY03	Change	1HFY02	1HFY03	Change
Material costs	551	873	58 5%	1,026	1,515	47 6%
Staff costs	169	141	-16.8%	306	269	-12.1%
Other expenditure	256	321	25 7%	513	550	7.2%
Total expenditure	976	1,336	36.9%	1,846	2,334	26.5%

Source: www.equitymaster.com

improving efficiency, the company started concentrating on improving the topline. The company is banking on exports and services to drive its growth. The company is also attempting to get more of international business. It has acquired 100% stake in ME Engineering Ltd., a UK-based company with expertise in design and project management in energy engineering, through the wholly-owned subsidiary, Thermax International. It even set up Thermax Inc., USA, to function as a front-end for all businesses in North and South America. Thanks to these moves, Thermax is able to get two-way benefit—one is earnings through export of products from Pune to international subsidiaries and second, to improve its topline by the profits made by these sister companies.

No wonder then that Aga and Kulkarni have made exports a thrust area for the company. Interestingly the company is doing well on this front. Exports increased by 12.5% in 2001-02 despite a depressed global market. Also, the vapor absorption chillers sold in the US market received the Electrical Testing Laboratory approval allowing the sale of chillers in the US under the Thermax brand, making the company the third in the world outside the US to have received this accreditation. The company is now looking for opportunities in the Russian market through its wholly-owned Russian subsidiary and plans to increase its operations in the East Asian markets while boosting the operations of its existing foreign subsidiaries in the UK and US. The company recently announced that it had already won export orders worth about $3.5 mn in the first two months of the current fiscal.

Thermax has zeroed-in on a new mission statement of being a global organization delivering sustainable solutions in energy and environment. As part of this renewed mission, the company is experimenting with a services model as the future growth arena. The services model envisages project-based work, which get higher margins, rather than selling products. Already, 13 new services projects are under pilot runs, and are soon to be launched. The service business is considered a key initiative because these days customers prefer total integrated solutions and expect the supplier to be responsible for his utilities. The company expects that its service initiative would bring in revenues of Rs. 80-100 cr over the next 3-4 years.

The company expects a 15% growth in topline in 2002-03 over the last fiscal despite the drought situation and war clouds over various parts of the world. Even though the Indian market was expected to grow at around 5%, the company is targeting a growth rate of at least 10%.

Thermax's international expansion enables it to generate earnings through exports and improves its topline by the profits made by its sister companies abroad

Regaining financial health

Even in the face of the economic slowdown and a slump in the capital goods sector, this Pune-based energy and environment company made a profit of Rs. 24 cr in the year ending March 2002. Profit before tax was up at Rs. 30.91 cr (as against the previous year's loss of Rs. 10.47 cr) and Earnings Per Share (EPS) in 2001-2002 was an impressive Rs. 10.32, compared to last year. What's more!, Thermax posted a net profit of Rs. 5.1 cr for the quarter ended December 31 (DQ), 2002 as against Rs. 2.6 cr in the quarter ended December 31, 2001. Total income increased from Rs. 106.590 cr in DQ-01 to Rs. 120.250 cr in DQ-02. Thermax ended the first half of FY03 with a 36% topline and a huge

Profit & Loss Account (Values in Rs. mn)		
	Mar. 01	Mar. 0
Net Sales	4,726 00	4,585.5
Other Income	318 60	354.7
Total Income	5,044.60	4,940.2
Expenditure	-4,965.90	-4,407 1
Operating Profit	78.70	533 1
Interest	-37.00	-29.7
Gross Profit	41.70	503.4
Depreciation	-117 10	-120 2
Profit before Tax	-75.40	383 2
Tax	-27.50	-69.0
Profit after Tax	-102 90	314.2
Extraordinary Items	-29.30	-74 1
Net Profit	-132 20	240.1

Source: BSE (www.bseindia.com)

152% bottom line growth YoY. Tl only shows how rectifyi 'company-related' problems c keep a company bouyant even in harsh business environment. F Thermax, correcting its intern problems lifted up its financia even though the busine environment continued to depressed.

Future: Boiling or chilling?

Then again Thermax managed turnaround driven by co reduction, revamping its board a concentrating on core business. Chayya says, "The prese management (executive and nc executive) is completely responsil for the turnaround. Focus was cost-cutting—the topline growth, you notice, is on low base a primarily from exports and o order of Shree Cement for its MW Captive Power plant." But t future might require much mo because large bankable order li Shree Cement might not always around the corner. May be Chay is right when he says, "Primar what company can do, it has alrea done. Though it still has a target lower material cost further. It w achieve the lower material cc target plus its export target. Exce for that, only pick up in demand c help."

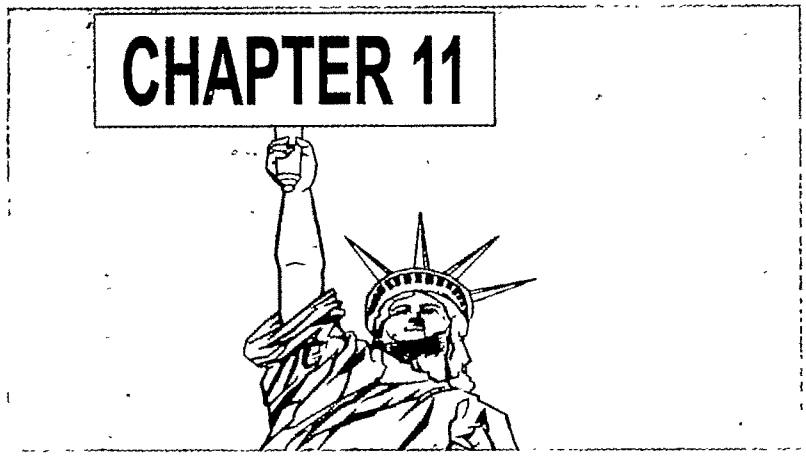
C S V Rat

Reference # 1-2003-04-08

US BANKRUPTCY LAW

Chapter 11: Use and misuse

Is Chapter 11 of American Bankruptcy Law really serving the purpose?



In the continuously slowing economy interspersed with mild signs of recovery every now and then, corporate America is witnessing a new condition—corporate bankruptcy. Year 2002 witnessed bankruptcies and left investors and shareholders scared. The year started with the collapse of Kmart, Global Crossing, Adelphia Communications, WorldCom and UAL, and Conseco is the recent one to jump on to the bandwagon. A quick review of the bankruptcies in 2002 says it all. Corporate America has seen half of the 10 largest corporate failures in history, as measured by assets in 2002. For example, Kmart when filed for bankruptcy was figured as No. 6 on the all-time bankruptcy list but at the year-end it slipped to the 10th slot.

Initially, bankruptcy began as a creditor's remedy and eventually evolved into a source of relief for debtors from financial distress. The trend is that American companies prefer protection under Chapter 11 rather than going for Chapter 7. Chapter 11 gives a firm temporary protection from its creditors, as they work out on its value and decide on the proportionate share that each interested party shall hold in the company that eventually emerges as bankruptcy protection. This is unlike in many other countries where a company will be liquidated if it cannot meet its obligations to creditors.

Companies file for bankruptcy even in a generally stable economic environment—as certain industries experience instability in times of economic prosperity. For example, years before recession hit America, the steel industry suffered from the adverse impact of high levels of low cost foreign steel imports, which resulted in the Chapter 11 bankruptcy filing by six steel companies during the pre-recession period, including Acme Metals, Laclede Steel, Gulf States Steel, Northwestern Steel and Wire, Wheeling-Pittsburgh and LTV. Companies may also file for Chapter 11 for reasons wholly unrelated to the economy or financial conditions, such as to eliminate contractual obligations. For example, Columbia Gas Transmission Corporation (TCO), a natural gas pipeline, filed for Chapter 11 protection in order to reject certain above-market long-term 'take or pay' contracts with producers of natural gas. TCO effectively used the bankruptcy process to eliminate those costly contractual obligations and to effectuate a global settlement with the producer parties to those contracts.

Is the system effective?

The efficiency of Chapter 11 is now under scrutiny. Of the 10 biggest bankruptcies since 1978, seven are now in the courts, dragging behind them an aggregate asset of nearly $300 bn. The rate of successful Chapter 11 reorganizations is depressingly low, sometimes estimated at 10% or less. J Scott Bovitz, former president of the Los Angeles Bankruptcy Forum opines, "Many companies filing Chapter 11 do not have a core business to save. Other companies wait too long to file—the business cannot be resuscitated. Some apparent Chapter 11 'failures' are really 'successes', (because Chapter 11 facilitates sale of assets during the bankruptcy period)."

A particular concern in industries such as telecom and airlines is that bankrupt firms return with manageable debts and compete with healthier rivals and eventually force them to go for bankruptcy protection. Consider the case of United Airlines. The decision of the company to seek protection under Chapter 11 has created ripples in the airline sector. Industry giants feel that it can possibly bring down other American carriers. With two national network carriers now in Chapter 11 (the other is US Airways), managers at Delta and Continental, who are already worried by the persistent rise of the low-fare carriers led by

Southwest and JetBlue are getting jitters. Companies under Chapter 11 relieved of the need to meet interest payments might cause havoc in the market by slashing fares. That is precisely what may happen now if United Airlines decides to take advantage of bankruptcy protection to steal business from rivals.

Another criticism of Chapter 11 put forth is the rule that allows the debtor in control of bankruptcy process. This essentially means that managers who are responsible in bankrupting a firm will have a say in restructuring it to keep it alive. As has been proved in most of the cases, leaving incumbent managers in charge of a bankrupt firm has resulted in the recovery of the firms from bankruptcy to seek protection under the very same Chapter 11 after some time. Nothing wrong in making an attempt to restructure and continue the business but what if the business is not worth its prolongation. The incumbent managers shouldn't be allowed to monitor the restructuring unless the creditors committee regularly monitors them. Even though there is an option for the creditors committee to appoint a trustee in case the managers are proved to be ineffective, experience shows that the creditor committees can more often get blinded by the rosy picture shown by the managers.

A quick look at the bankruptcies of late 1980s and early 1990s reveal that among companies that went bust due to high leveraged buyout, restructuring the debt revealed essentially viable firms underneath. The managers of a bankrupt firm gain more, not less, control over their fate. For instance, Chapter 11 gives debtors the right to propose a restructuring plan within 120 days. But as seen in many cases judges routinely extend this deadline. Managers at companies like Polaroid and Enron were allowed to sell assets before even drafting a restructuring plan, thus avoiding the approval of creditors. After filing for bankruptcy under Chapter 11, Enron has sold a wind farm, its energy-trading arm and a construction company, among other businesses.

Chapter 11

Chapter 11 is a reorganization proceeding, typically for corporations or partnerships. Individuals, especially those whose debts exceed the limits of Chapter 13, may file Chapter 11. In Chapter 11, the debtor usually remains in possession of his assets and continues to operate any business, subject to the oversight of the court and the creditors committee. The debtor proposes a plan of reorganization, which, upon acceptance by a majority of the creditors, is confirmed by the court and binds both the debtor and the creditors to its terms of repayment. Plans can call for repayment out of future profits, sales of some or all of the assets, or a merger or recapitalization. Chapter 11 bankruptcy is a form of reorganization available to individuals, corporations and partnerships. It is the usual choice for large businesses seeking to restructure their debt. If the debtor's management is ineffective or less than honest, a trustee may be appointed.

A creditors committee is usually appointed by the US Trustee from among the 20 largest, unsecured creditors who are not insiders. The committee represents all of the creditors in providing oversight for the debtor's operations and a body with whom the debtor can negotiate an acceptable plan of reorganization.

A Chapter 11 plan is confirmed only upon the affirmative votes of the creditors, who are divided into classes based on the characteristics of their claims, and whose votes are a function of the amount of their claim against the debtor. Chapter 11 is probably the most flexible of all the chapters, and as such, is very popular with the companies.

Compared to Chapter 11, Chapter 7 bankruptcy is a liquidation proceeding wherein the trustee sells the debtor's assets. The proceeds are distributed to creditors according to the priorities established in the Code.

Source: www.bankruptcy-expert.com

Feeding off the carcass

Another nagging concern is the high costs associated with restructuring. Companies seeking protection under Chapter 11 promise years of feasting for the lawyers, accountants, financial advisers, public relations firms and consultants who specialize in the 'restructuring' business. America's bankruptcy industry is expected to book revenues of $6 bn in 2002. Getting into micro details, bankruptcy fees at Enron may reach a figure of $700 mn or more for two years. If this looks exaggerated, then the fees at WorldCom can blow one's mind off. Bankruptcy fees at WorldCom is expected to touch $1-bn mark.

In spite of all these concerns, parties involved in the bankruptcy process claim that the work is worthy. They emphasize that in restructuring under Chapter 11, jobs are saved, value is preserved and the company is recycled into the economy. But it is more often proved that under Chapter 11, the patient waits in pain as his condition deteriorates while everybody argues about the treatment. The result is myopic strategies that result in bare survival of the firm with the risk of further bankruptcy still hanging.

In this regard, Lynn LoPucki, a professor at the law school of the University of California, Los Angeles, has built a database of all public companies with assets of over $100 mn that have filed for Chapter 11 bankruptcy since 1980. Most firms get second chances: Out of 569 cases of filing under Chapter 11, only 89 companies failed to emerge from bankruptcy. The remaining, however, went on to fail again. LoPucki looked at the fortunes of firms that emerged from bankruptcy between 1991 and 1996. Within five years, 29% had gone out of business, with two-thirds of these

liquidated or merged in distress. Chapter 11 is proving to be a blessing in disguise to many companies.

These companies are rather testing the limits of Chapter 11 and America's tolerance for bad credit. Harvard Industries tops this infamous list. Last year the company went bust for the fourth time. The company's ability to survive repeated failure says it all. Managers at the company propose plans that please investors but never have actually worked in the long run. Founded as a Massachusetts brewery by a German businessman in the 1930s, the company was subsequently seized by American Government and later expanded its horizons into electronics, furniture and armaments before going bust for the first time in 1972. The company was reorganized in 1983 and achieved instant success. A leveraged buyout has resulted in bankruptcy and the process continued with the firm every time convincing its creditors and investors with new plans of survival.

Destiny of shareholders

When a company enters bankruptcy protection, it emerges as a completely different company, with the only real similarities being in name and business. As equity shareholders are owners of the company and take the utmost risk, in a bankruptcy, after reorganization, creditors and bondholders get the equity in the new firm freezing out the old shareholders. Scott Bovitz argues, "In Chapter 11, the value of business is usually maximized for the benefit of creditors and shareholders. There is no reason to treat equity shareholders 'better' than creditors, if the value of the business is insufficient to pay creditors in full."

The payment is prioritized in the following manner.

First the lawyers get paid, because no one does bankruptcy work free of cost. Then there are US trustee fees. Then secured creditors. Then the lenders who have the lien. The bondholders get some equity. In rare cases, a bankrupt company can net nifty gains for the original shareholders. In 1977, St. Paul & Pacific Rail Road filed for bankruptcy but while it was reorganizing, the value of the land it held as assets surpassed the amount it held in debt, netting a windfall for the lucky shareholders. If shareholders don't lose everything, they could receive a tiny share of equity in the reformed company by way of a massive reverse stock split. This means shareholders could end up with one share for every 100 they held.

What next?

Looking at the poor success rate of companies that reorganized themselves under Chapter 11, most of the times the bankruptcy code is acting against the free market efficiency. The fittest alone survive, but they've to fight with companies that (mis) use the protection under bankruptcy code and refuse to die. The code allows companies to stay in business with an unfair advantage over competitors who have to pay their debts and also pay interest on those debts. Although Chapter 11 is intended to help sick companies in their efforts to surviv, one has to doubt whether the code is being abused.

The year 2003 may see even more of a number filing for protection under Chapter 11. *BusinessWeek* is of the opinion that with the economy still waiting for a loft, analysts at credit-rating outfits are predicting that roughly one in every 13 companies with non-investment grade debt, or 8%, will default and declare bankruptcy in the next 12 months. As the number grows, there will be more pressure on the US Government to fix the problems brought by Chapter 11.

One way to avoid cases like Harvard Industries would be through making amendments to Chapter 11 by refusing to accept the bankruptcy protection under it if a company files more often. In other words, limiting the number of petitions by the same company over a period could limit the abuse of Chapter 11 and retain the objective of providing protection to genuine cases.

Shashidhar Mishra

Reference # 1-2003-04-09

The Notorious List:
The Largest Chapter 11 Bankruptcies, in $bn

Company	Bankruptcy Date	Total Assets ($bn)
WorldCom	July '02	103.9
Enron	December '01	63.4
Texaco	April '87	35.9
Financial Corp of America	September '88	33.9
Global Crossing	January '02	25.5
UAL Corp	December '02	25 2
Adelphia Communications	June '02	24 4
Pacific Gas and Electric	April '01	21.5
MCorp	March '89	20.2
Kmart	January '02	17 0

Source www.bankruptcydata.com

> **In Chapter 11, the value of business is usually maximized for the benefit of creditors and shareholders. There is no reason to treat equity shareholders 'better' than creditors, if the value of the business is insufficient to pay creditors in full.**
>
> **J Scott Bovitz**
> *Former President*
> *Los Angeles*
> *Bankruptcy Forum*

ROYAL AHOLD

Losing hold?

Royal Ahold, the third largest retailer in the world, shattered the myth of Europe's immunity to corporate malfeasance when it revealed accounting irregularities.

The last couple of years will be remembered for their shocking revelations of accounting scandals. Even as America was flooded with accounting restatements (1,200 in the last five years), Europe felt secure under the assumption that this was a typical American ailment; and somehow European companies were different. But that faith was lost when Royal Ahold, a Dutch company, which happens to be the third largest retailer in the world announced that it would have to restate the earnings of 2001 and 2002 due to accounting irregularities. There were other problems too that had suddenly surfaced at Ahold. The transactions of its Argentine subsidiary were cast under allegations of fraud, accounting problems in consolidating the results of its Scandinavian subsidiary, ICA, and its burgeoning debt to name a few.

Fallen star

Ahold, is a 116-year-old company that serves 40 million customers in 27 countries across the world and employs 4,60,000 people. It has risen to its prominent position mainly through a chain of acquisitions; beginning with the early 1990s, Ahold's history is full of acquisitions it has made across the world. Its strategy has been drastically different from Wal-Mart and Carrefour, the number one and two players respectively who precede Ahold in the retailing industry. Wal-Mart uses a mixture of local brands and its own very strong brand name across its chain of stores. Carrefour, on the other hand, operates under its own brand name irrespective of the location. A Carrefour store looks exactly the same anywhere in the world. Ahold's strategy is in stark contrast. Most of its stores are chains that have been acquired and operate with their own names.

Ahold acquired a number of supermarkets, retail chains etc., which gave it inroads into US, Latin America, Europe and Asia. Ahold owns brands such as Stop & Shop, Giant-Landover, Giant-Carlisle, Tops, Bruno's, US Food Service, online grocer Peapod, Albert Heijn, Schuitema, Etos, Gall & Gall, Deli, ICA Group, Ahold Polska, Ahold Czech Republic, Ahold Slovakia, Ahold Supermercados, Jerónimo Martins, Bompreço, Disco, Santa Isabel, CARHCO, La Fragua, CSU, PT Ahold Indonesia, CRC Ahold, the list just goes on.

Ahold has ambitious plans of using Internet to enable its widespread subsidiaries to share knowledge and skills. Ahold's stores do not follow a single format or are restricted to any single type. While these acquisitions boosted the sales of Ahold greatly they also had other unintended consequences. In an article 'The Biggest Grocer You've Never Heard Of', *Fortune* observes, "The company refers to its strategy as 'multi-local, multi-format, multi-channel', which is enough to make anyone nervous." The fact holds all the more good in an environment where investor confidence is just about totally eroded. One of the offshoots of this acquisition spree is the €12 bn debt that has been accumulated in order to fund these acquisitions. In addition, these acquisitions have cradled some of the biggest problems that Ahold is facing today.

Pandora's box

To begin with, the accounting irregularities that are at the crux of Ahold's recent troubles are rooted in US Food Service, a food service company that it acquired in 2000. US Food Service supplies food to hospitals, schools and other institutions. On February 24, 2002, Ahold announced that its auditors, Deloitte Touché have found that 'promotional allowances' were improperly accounted at US Food Service, which could reduce the profits by $500 mn after restatements. Promotional allowance or vendor allowance as this is also called is a delicate issue of accounting for many retailers. Manufacturers provide retailers such as Ahold a discount for buying goods in bulk or for meeting certain targets in sales volumes. These reduce the cost of sales and hence boost profits. How and when should promotional allowances be accounted for in the books remains an unresolved issue (see box: Accounting for Promotional Expenses). Problems arise when a company is aggressive in accounting for these vendor allowances and especially when it accounts for them without actually meeting the targets.

Ahold is neither the only company nor the first one to indulge in such aggressive accounting of promotional allowance, but it is the largest. SEC is investigating the case of Nash Finch Co., which faces allegations that it had used promotional allowances to reduce the cost of sales, to the tune of $19.1 mn. Other grocers such as A&P and Fleming Companies, Inc. are also subject to such inquiries.

Why would a company indulge in such a practice or for that matter in any other kind of accounting jugglery? The answer lies in the pressures from the markets to deliver positive results, double-digit growth quarter after quarter,

irrespective of the market circumstances. When asked about the reasons for Ahold's accounting tricks, Dr. Joseph V Carcello, President—Auditing Section, American Accounting Association and Associate Professor at University of Tennessee confesses, "Although I don't know the reasons why Ahold resorted to accounting tricks, the most likely reasons are pressure to meet earnings targets (either internally set or imposed by outside analysts), earnings-based bonus plans, or incentives to keep the stock price high due to stock-based compensation plans."

In the third quarter of 2002, Ahold had reported a quarterly loss for the first time in 30 years; while it is an enviable track record that the present revelations force one to think again about the continued positive figures. It is a well known and probably treasured truth that stock option plans and excessive executive compensation are not a part of European culture but Ahold was one of the exceptional companies that had tried to follow the American path. It had stock options plans. The ex-CEO Cees van der Hoeven cashed $3.3 mn in options during 2000 and 2001. The ex-CFO Michiel Meurs cashed his share of $1.2 mn. Both of them have resigned owing responsibility to the US Food Service episode.

Transparent books?

The second major issue that Ahold is currently facing is about consolidation of the results of some of its subsidiaries, ICA Ahold, Jeronimo Martins Retail and Disco Ahold International Holdings. Ahold had till now consolidated the full results of these entities into its results with minority share in earnings and equity then deducted during the relevant periods. Now, Ahold has come out saying that it will proportionately consolidate the results from these subsidiaries commencing from fiscal year 2002. It has also announced that it will restate historical financial statements using proportionate consolidation. Ahold claims that these "deconsolidations on Ahold's net income, earnings per share and shareholders' equity will be under Dutch GAAP" while the impact under US GAAP is being reviewed.

Due to its widespread operations there is great confusion about the accounting standards being adopted by Ahold. The figures when reported as per US GAAP are very different from those reported as per the Dutch standards and Ahold is blamed for not disclosing 'all' the necessary information to investors. For instance, after the implementation of FAS 133 related to goodwill impairment, the 2001 results of Ahold varied widely and Ahold highlighted the Dutch figures while downplaying the figures as per US GAAP As per Dutch standards earnings for 2001 were around $1 bn, almost the same as in 2000. On the other hand as per US GAAP, which demanded goodwill impairment, the earnings fell to $109 mn as against $722 mn a year earlier. Ahold highlighted the net earnings as per the Dutch GAAP in the front of the annual report while the figures as per the US GAAP were given in small print at the back of the report. Ahold faced severe criticism for this move and its share price took a severe beating. Given the untrustworthy environment many investors started worrying about the quality of earnings and whether Ahold was trying to hide. The present scenario would only confirm their doubts.

There is yet another event, which goes on to prove the lack of transparency in Ahold's financial reporting. In 1998, Ahold acquired 50% stake in Disco Ahold International, its joint venture with Velox Retail Holdings (VRH), a company owned by the Peirano family. The company operates supermarkets in Argentina, Chile, Peru and Paraguay. Ahold was required to purchase the remaining 50% stake in the joint venture in case VRH defaults, which it did in 2001. Ahold was forced to buyout the remaining 50% stake for $492 mn. However, this clause was not reported to the investors even though the company was aware of this obligation as early as 1998. It finds mention only in the Annual report of 2001 In addition, it faces investigation for the frauds committed at Volex And angry investors are questioning as to where did the money that Ahold paid vanish?

Accounting for Promotional Allowances

Manufacturer rebates can be recognized when one purchases the item as long as the cash has been received or there is a high probability that the cash will be received. The manufacturer rebate acts as a reduction of the cost of the product.

Promotional allowances, such as those received by Royal Ahold from food manufacturers, can be seen in either of two ways First, they may be tied to volumes sold, in which case they act to reduce the cost of sales by Ahold to restaurants and other consumers Second, they may be given in anticipation of some services to be rendered by the distributor, such as advertising or increased shelf space In this case one might argue that the distributor earns the revenue whenever the service is provided In Ahold's case, it does not matter which viewpoint one takes, for Ahold was booking the revenue as soon as they received cash, regardless of whether they had performed any service and regardless of any evidence concerning the volume of sales (See EITF 02-16).

The above answers are for the distributor From the manufacturer's viewpoint, the rebate reduces sales, as would any allowance or discount The promotional allowance can be seen either as a marketing cost (consistent with the service view) or as a reduction of sales, consistent with the volume story.

By Prof J Edward Ketz, Associate Professor of Accounting, The Pennsylvania State University, and the author of the forthcoming Hidden Financial Risk

The present

Ahold had initiated investigations into the alleged illegal dealing at its Argentine subsidiary. The good news is that these investigations revealed that they will not have any impact on the financial statements of the company. Yet another good news though mired in controversy regards to the €3.1 bn credit line that Ahold has successfully negotiated with the consortium of banks consisting of ABN AMRO, Goldman Sachs, ING JP Morgan and Rabobank. The arrangement gives the much necessary liquidity to Ahold at this crucial juncture. Prof. J Edward Ketz, Associate Professor of Accounting, The Pennsylvania State University opines, that the "credit line is important since they have some debt coming due soon that needs refinancing". But there are number of covenants that the credit line brings with it including the clause to release the second tranche of payment only after the audited annual accounts are submitted by May. But nevertheless the credit line offers a temporary respite to the issue of liquidity at Ahold.

The timing of the announcement and the credit line, which followed at its heals of Ahold's accounting problems raised concerns that Ahold had withheld the information from the markets till it had finalized the credit line with banks. In fact, Ahold had informed, Authority for Financial Markets (AFM), the Dutch regulators, and the Securities and Exchange Commission that it was looking into accounting irregularities on February 20, four days before the news was made public. There are fears of insider trading during this period. The implications of the accounting restatements could be far-fetching if it was found that they involved fraud. Already there are a number of class action suits filed against the company. And given the Sarbanes-Oxley Act there is every possibility that managers would be facing civil and criminal liabilities. The share price of Ahold has anyway taken a severe beating. In November itself Ahold had launched a four-point program to minimize costs, reduce debt and review its portfolio. It might as well go as per the plan and survive this crisis if it does not involve fraud.

Europe had claimed that its principles-based standards were better than the rules-based approach of the US. But Ahold proves that it is not so

Both sides of the Atlantic

Ahold, by far the largest accounting restatement to come into light has rudely awakened Europe to reality. To its due credit, America had reacted fast to the numerous accounting scandals by passing the Sarbanes-Oxley Act, establishing a public oversight board for auditors and undertaking a number of corporate governance changes. Authorities did not budge from their stand even as Arthur Andersen one of the prestigious big five accounting firms was going under. In fact, there are many who feel that it is this tough stand of American regulators that led to heightened sensitivity among auditors and forced Deloitte to come out clean with these accounting irregularities. It is worthwhile to remember that it was the auditors from Deloitte who traced these aggressive practices while auditing the 2002 financial statements. This brings us to the important question of regulatory environment in Europe. European authorities and companies have been lobbying heavily to avoid being subject to the Sarbanes-Oxley Act but the Ahold episode raises a number of uneasy concerns.

The regulatory environment and the machinery for supervision in various European countries is lax at best when compared with the SEC. Either regulatory bodies are not existent or where they do they lack sufficient power to questic and impose discipline. Dr. Carcel sums up the differences betwee Europe and US in the followir words, "Europe does not tend have a securities regulator with much clout as the US Securities ar Exchange Commission. Als accounting principles in Europe a more principles-based rather tha the rules-based standards mo common in the US." For a long tin now, Europe had claimed that i principles-based standards we better than the rules-base approach of the US. But Ahol proves that it is not so.

Prof Ketz observes, "Th regulatory environment is tighte in the US because of cultur differences and differences i capital formation." He furthe elaborates, "Germany, for exampl relies primarily on capital fro banks, and banks can obtai whatever information they wa from corporate managers durin the application process. There i less need for banks to rely o regulators to enforce laws. The U places much greater reliance o obtaining capital from the publi and the public can get informatio only through corporate financi reports and press releases." It is thi culture that forces US to react fa in order to uphold the strength of i free markets.

European Union is set to ado International Accounting Standard (IAS) by 2005, but the preparednes in many of the countries is far belo the expected standards. And to wh extent they will be able to ste future Aholds is a question in itsel As of now, Europe's regulator environment with regard t auditors, corporate governanc practices etc., is very slack whe compared to the reformed US.

There is no dearth of people wh have dubbed it as Europe's Enro While the whole truth is yet to b out, Ahold could be the flag-beare of Europe's regulatory reform.

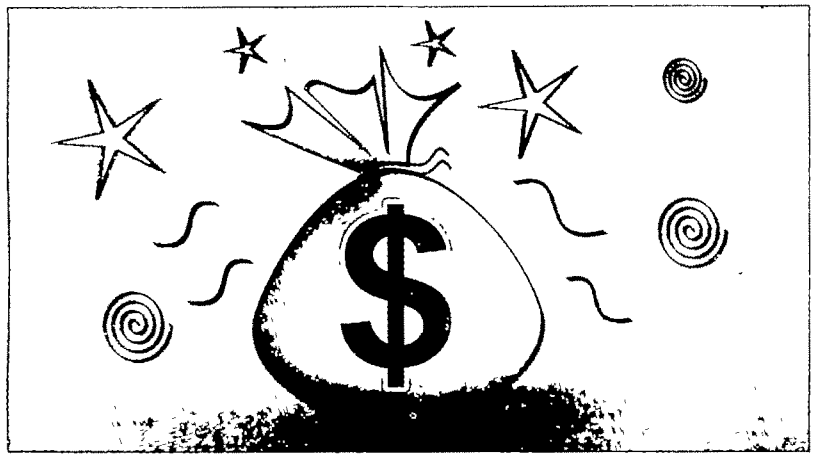
D G Prasun

Reference # 1-2003-04-10

DIVIDENDS

A new new thing?

The next big trend in Wall Street seems to be driven not by a new new thing, but the old-fashioned notion – that healthy dividends are a sign of superior corporate prospects.



In the late 1990s, a generation of stock investors came to regard dividend as a quaint concept whose time had come and gone. In the 1950s, nine out of 10 American companies paid dividends. Today, only one in five does. The exuberant 1990s' market ignored old-fashioned dividend-paying stocks in favor of profitless companies promising excellent growth rates. But a confluence of events of late made investors to rethink. The stock market turned south and interest rates on savings accounts plunged to new lows giving a new life to the idea that equities should provide investors with a regular payment of cash money—an income stream that would be there even if capital gains weren't. If stock price appreciation is much harder to come by in this decade than the last—a distinct possibility—then dividend income could mean the difference between a poor return and a decent return on equities. Now, a White House proposal to eliminate tax on dividends should be another big boost.

However, bubble era rejection of dividends still persists. According to Standard & Poor's, only 72% of companies in its S&P 500 index paid a dividend last year, down from 94% in 1980. And payout rates shrank much more. The S&P's yield (annual dividend per share divided by share price) shriveled from more than 6% in the early 1980s to a minuscule 1.4% in 2001. Last year, the average dividend payment shrunk by 3.3%, the biggest drop in 50 years. Barely one-fifth of all listed American companies paid a dividend in 1999.

However, dividends have been key part of stock's allure, historically. From 1926 through 2001, 43% of the return on large company stocks has been delivered in the form of dividends. From 1900 to 2000, 4.1 percentage points of the 6.7% average annual real return on US stocks were derived from dividends. In the 1960s, for example, the average total return on the Standard & Poor's 500 index was 7.8% a year, and dividend income accounted for 3.3% of that total; the rest was capital appreciation.

Dividends disappearance

There are several possible explanations for dividends disappearance, but none seems adequate by itself. The main reason, according to Eugene Fama and Kenneth French, professors of finance at the University of Chicago and the Massachusetts Institute of Technology respectively (in their study "Disappearing Dividends"), is that the sort of companies that are traded on America's stock markets have changed radically. Until the early 1970s, exchange listing was the preserve of large, profitable firms—that generally pay dividends. But as Nasdaq imposed less stringent listing conditions, new companies for which profitability was not a compulsion entered the domain. The upshot: America has many more companies than it did, but that fewer of them make profits and even fewer pay dividends. Not only the companies had no profits to distribute, but also the companies with profits choose to retain them for the glorious growth opportunities. Even among very profitable companies, only 32% pay dividends, half the proportion that did 20 years ago. For both reasons, more growth companies meant fewer dividend-payers.

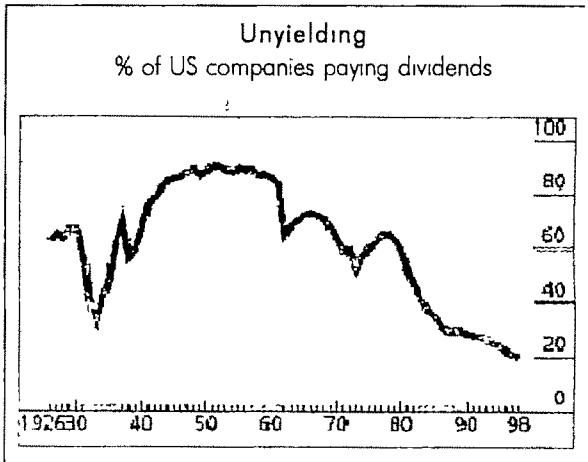
One explanation is shareholders do not want dividends, as they represent income, which in America is taxed at a top federal rate of 39.6%. By leaving profits in the firm, investors can defer this tax; cash in a capital gain, which is taxed at only 20%. White House is proposing to eliminate taxes on dividends. Keith Black, Assistant Professor of Investments, The Center for Law and Financial Markets, Illinois Institute of Technology says, "In the past, corporations rightly believed that investors did not like dividends

given their tax disadvantages. If the proposal passes, it is likely that firms will start paying new or higher dividends, and that the market will reward dividend paying firms with higher stock prices." But taxes do not in themselves explain the decline in dividends.

Another explanation is that dividends have not disappeared, but assumed a new guise: Buy-backs. They have risen from 3-5% of annual corporate profits during the 1970s to 26% in the 1980s and 1990s. Some companies do not pay dividends, but at the same time have huge buy-back programs. Given the tax issue the reasoning goes well. But share buy-backs are not replacing dividends as such, because most of the companies buying back shares also happen to pay dividends. But buy-backs do affect dividends, because the companies are not using buy-backs to distribute profits but to avoid diluting existing shareholders when they grant employees options on new shares. Dell last fiscal year spent $3 bn on stock buy-backs and paid no dividend. Intel spends about $4 bn each year on its own shares, while it pays out just $530 mn a year in dividends. If they pay dividends instead of buying back shares, the number of outstanding shares would rise and with the company's earnings spread over a higher number of shares, the net effect would be a wash.

So regardless of the provisions of Bush's tax plan, Intel, Microsoft, Dell, and other cash-rich technology companies may not pay meaningful dividends (though Intel pays a dividend, and it's 8 cents per share and Microsoft's first ever dividend yield is microscopic 0.28%) because of options handcuff. The tax proposal may alter the incentives, but it won't change the underlying dynamics that favor stock buy-backs over dividend payouts.

One real reason for dividends turning unfashionable, as many experts would admit, is the change in corporate philosophy than with taxes or buy-backs. Many growth companies feel that the best way to reward shareholders isn't to give away the cash that fuels their growth but rather to invest earnings back into the company through R&D or strategic acquisitions. Paying dividend for them meant weakness, as Richard J Wayman, co-founder, Researchstock.com feels, "Paying dividends means that the company cannot find a better use for the money—an acknowledgement that their growth potential is limited."



Source: Eugene Fama and Kenneth French

This was supported by academicians with their dividend valuation models that say that a firm need not pay dividends if it thinks that its own investment opportunities are better than those available to shareholders elsewhere. And also by the Noble prize winning *Dividend Irrelevance Theory*, by Merton Miller and Franco Modigliani, that argued that level of dividends should have no effect on the value of a share. However, not all agree that dividends are irrelevant, but such quibbles were largely ignored so long as shareholders were reaping capital gains in the bull market. For instance, it had long been observed that a firm's share price tended to fall if a firm cut its dividend. More recently, some technology firms have seen their shares suffer when they have announced a plan to pay dividends.

Dividends – Reassurance?

Though dividends are still an enigma, eluding any single theory, they are not irrelevant. It's just that they have lost less relevance in bull markets. For most of the century, before the bull market of the 1990s, the dividend yield was one of the most watched measures in the stock market. Then came the idea that big dividends are a big tip-off that a company has no good idea of how to turn its cash into future growth. Such thinking reached the peak and dividend yield turned so low as to make dividend payments a sideshow in the total return from stocks. Keith Black says "If price gains are extremely high shareholders don't care much about the small incremental return from dividends."

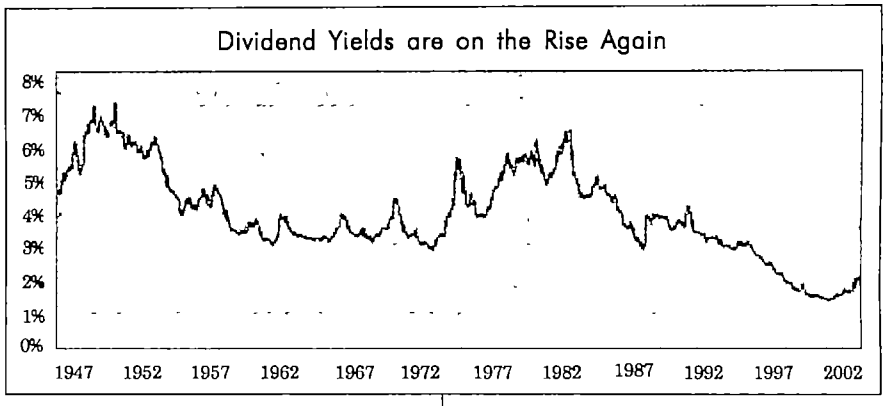
But three years of downward trend for stocks have left investors weary and wary. Investors wanted to get something back even if the price goes down. Only with stocks that pay a dividend does one get something—if they own a stock that doesn't pay a dividend, they felt it's nothing more than speculation. With this change in investor psychology came the revival in interest in dividends. Keith Black says "In a falling market, where price returns to equities have been negative, investors often focus on the risk of the market, while they focus on returns in a bull market. If a company pays a high dividend they are likely to be less risky and have less negative returns in a bear market. Companies that pay high dividends are less likely to engage in aggressive accounting practices because they have to back up their earnings with actual cash that is distributed to shareholders." In 2002, many investors—hard-bitten by scandalous losses in their aggressive-growth mutual funds—have poured $4 bn into equity

income funds, which focus on yield-bearing shares. That's up from $2.6 bn for 2001 and contrasts with dramatic outflows of $16.7 bn in 2000.

Wayman says, "In a market focused on growth/momentum stocks, dividends are viewed as a 'last resort' because the company can't find any other way to invest its money (so they give it back to the shareholder). In the post-bubble world, investors are changing styles from growth to value, and dividends have value when the markets are trading sideways or falling." Investors realized that there's some security in receiving regular cash payments from a company. Dividends signal share's value and desirability: Only profitable, well-managed companies can afford to pay them. Dividends, give analytical information about the companies investing in. It's a sign not only of financial strength but also of management discipline and management commitment to shareholders, helping to foil expensive mergers or expensive stock options for executives

There is also a view that dividends may be more reliable signals than the highly distorted earnings that companies have tended to report. The attitude is 'dividends can't lie'. Keith Black says "The companies with aggressive accounting often have earnings greater than cash flows, which leaves less cash for dividend payments. For carefully, conservatively managed companies, it is easier to pay dividends. Generally, the higher the dividends (given that dividends/earnings are less than 70%) the more honest the accounting of the firm." When it comes to being indicators of financial performance Wayman cautions, "While dividends cannot be manipulated, they can be cut."

Equally important, a robust flow of dividends acts as reassurance



that companies are not squandering their earnings. In the heady days of the late 1990s, many investors demanded that companies show double-digit earnings growth and saw a company's retention of all its earnings as an essential ingredient in fueling that growth. This encouraged corporate executives to invest earnings in less compelling opportunities as resources became available to fund marginally inferior projects. The telecom overindulgence is a prime example of this behavior. The irresistible cash hoard ended up burning a hole in the corporate pocket.

Dividends are no panacea. A dividend can cushion a stock's price, but will not necessarily keep it from collapsing

Warren E Buffett, the legendary stock-picking Chairman of Berkshire Hathaway, says, "We will either pay large dividends or none at all if we can't obtain more money through re-investment." Buffett tests the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least $1 of market value for each $1 retained. So, the crucial question for shareholders ought to be whether a company has profitable uses for its cash. If it has not, then it is better to return cash to shareholders.

Dividends – A panacea?

When it comes to market performance, a recent study by the investment firm, Multex, found that dividend payers generally outperform in both bull and bear markets. Despite the fall-off in corporate profits, 112 companies of the S&P 500 announced increases in dividends. That's the first time; dividends are rising ahead of earnings coming out of a recession. Keith Black says "Stocks in dividend paying companies have outperformed stocks of non-dividend paying companies by over 10% each year from 2000 to 2002. Returns of high dividend stocks are less volatile than returns to stocks that don't pay dividends."

In the coming year growth prospects for equities are likely to be meager too. So given that some blue chips offer steady 2% yields, investors might do better to get some of their expected payback through dividends instead of risking the full money on price appreciation.

To be sure, however, dividends are no panacea. A dividend can cushion a stock's price, but will not necessarily keep it from collapsing. In other words, stocks are risky investments, with dividend or with no dividend. But right now, they're just as important for the confidence they represent. As investor attitudes gradually swing back into balance, stocks should resume their traditional dual role of providing investors with a source of long-term capital growth and a steady stream of income from rising and suddenly fashionable dividends.

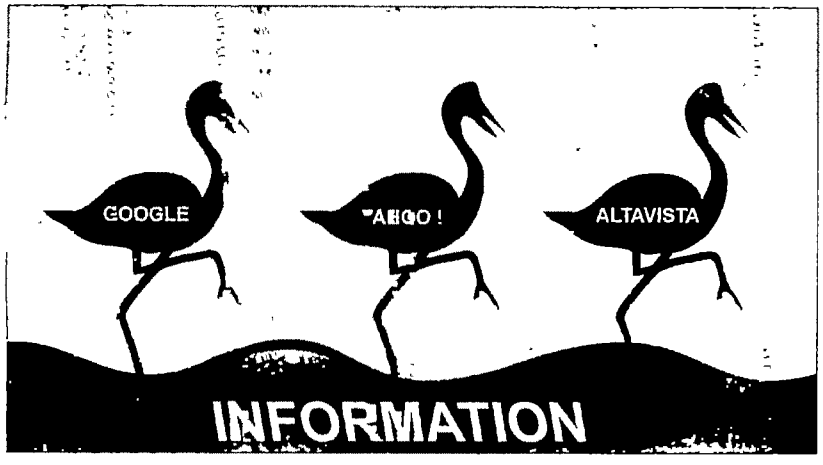
A Sowdeepti

Reference # 1-2003-04-11

SEARCH ENGINES

Battle for the search space

With Google flying high and Yahoo! recharging itself from a brief hibernation, the search game is just getting hotter.



For millions of Internet surfers across the globe Google needs no introduction. As a brand, Google now ranks well above some of the big brands like Coke or Colgate. Google in a way has revolutionized the search engine business. So far the giant of the search space was enjoying perhaps an unchallenged regime. But no longer.

Of late, the hitherto slow Web-based search business is suddenly seeing intense competition even as the dust over dotcom demise is yet to settle. The renewed activity in the business is posing a big challenge for Google to protect its territory. The response from the company has been quick and unprecedented—it is laced with consolidation as well as expansion into new, untested areas like Web-based publishing. Its rivals too are not sitting idle. Overture its most significant competitor in the search business too has shown tremendous aggression by buying two search engines AltaVista and Fast. Yahoo!, the other major competitor, which is now more a portal than a mere search engine, is fast expanding into new services. The key question is—Is diversification alone going to sustain pure search engine providers like Google?

'Search' for survival

Google, which so far was focused on search as its core business, has unleashed a slew of several new initiatives. In one of those moves, the search engine major recently announced to acquire Blogger.com, the site, which helps individuals, set up personal and easily updated Web pages, known as blogs. This forms a part of the company's plan to expand from selling search-related advertising links on its own site to selling them on partner sites as well. However, the move took the market by surprise as the acquisition marked expansion in a field that was not related to Google's core business. In fact, even going by the company's own admission, which boast of its laser-like focus on providing search-related facilities, the decision is quite surprising. Blogs have popped up all over the Internet, and Blogger.com's tools are some of the most popular; which boast of over a million registered users. Experts opine that with the search engine provider's latest move to sell links on non-search-related Web pages of Blogger and of the partner sites, Google is looking more like an advertising network like 24/7 Media and one-time ad seller DoubleClick, which use tracking technology such as cookies to monitor Web surfers and send them ads relevant to their interests.

In addition, the purchase could help expand the flexibility and reach of Google's already impressive data gathering and analysis technology For example, Google might find a way to use links posted by Blogger.com users to get faster intelligence on news circulating on the Web. That could bolster its recently launched news service, which crawls thousands of news sites looking for the most important stories, using proprietary formulae to determine a story's relevance. As is the case with its search engine, this selection process takes place without the intervention of human editors. While many in the blogging world applauded news of Blogger.com acquisition, a few raised concerns about the impact of the deal. Most blogs include many links to other websites and blogs. Experts observe that by acquiring the software that allows users to create blogs, Google will be buying loads of back-end data. As of now Google can, through its search engine, trace the first step of a trail that a user makes online. But, industry analysts say, by following the links included in blogs, Google will be able to keep going along that trail: How one site leads to another and so on. Also, for the first time, Google will host content that it will rank. However, the move has raised eyebrows among industry experts who say that smacks of a potential conflict of interest. The searchenginewatch.org says that there's a danger when the service

and the infrastructure are owned by the same body. The rewards of using one to profit from the other are very seductive, but it's ultimately bad for the ecosystem, it adds. Critics also express apprehension that Google might be sneaking into the privacy of Internet surfers. As one analyst opined—it's such a powerful search tool, it's hard to state what privacy on the Internet means anymore. It's like pulling a thread on a sweater. Already Google's rivals are worried that given the fact that they're beheld by Google's editorial search results for much of their Internet traffic. "This relationship has led to one pending lawsuit over Google's search algorithms, says searchenginewatch.org." Another concern is regarding the dilution in focus on part of the company. Theodoros Evgeniou, Assistant Professor, Technology Management Department, INSEAD, France, observes, "I believe that Google's core competence is in technology. In that sense, I believe Google should be focusing more on the corporate technology market." At the same time, he adds, "it does not have to stick with the search engine technology only—for example, it can bundle with this technology other tools such as knowledge management ones—but getting into publishing is a different path."

Danny Sullivan, an Internet Consultant and Founder of searchenginewatch.com, the site which keeps an eye over search service providers, observes in his newsletter posted on the website that the announcements stake out new territory for Google, piquing curiosity about what appears to be a new direction for the company, and raising some concerns as well. "They've always said, 'We'll be only focused on search.' How does (the Blogger.com purchase) have anything to do with search? It doesn't," remarked Sullivan. He says that at one level, the Blogger.com buy brings Google a step closer to the portal model, giving it a Web publishing tool akin to Yahoo!'s Geocities, which hosts and helps subscribers create personal websites.

In yet another significant move Google recently announced its decision to enter contextual ads segment. The move suggests that the search engine major is no longer solely about search, rather it is going to be much more than that. Sullivan observes that Google's entry into the contextual ad space has given it an advertising network product that is independent of search. In other words, there's no 'search' reason to explain why Google needs to place its ads on Web pages. "Business-wise, there's a good reason. Google has to stay competitive. If Google's competitors are expanding their search-oriented paid listings into the contextual space, then Google needs to do it as well, in order to please both advertisers and portal partners," opines Sullivan.

The search business, which relies for its revenues predominantly on advertisements, over the period has evolved into distinct models

However, Sullivan sees no solid reason behind Blogger acquisition. "There was no search need to purchase Blogger that I can see. Indeed, as suspected, it appears that Blogger was bought simply because it was probably cheap and because Google guessed it could figure out something to do with it in the future," he comments.

Search business – On different paths

While the search business is still evolving, the companies have been able to work on strategies to pursue advertising dollars; companies such as Yahoo! and Google are now towards different paths. Search advertising takes two forms.

> **"I believe that Google's core competence is in technology. In that sense, I believe Google should be focusing more on the corporate technology market."**
>
> **Theodoros Evgeniou**
> *Assistant Professor*
> *Technology Management*
> *Department, INSEAD, France*

The search business, which relies for its revenues predominantly on advertisements, over the period has evolved into distinct models—One, sponsored search or 'pay-for-placement', which involves putting a small number of paid-for links in a separate section at the top of a search page. As these searches are highly targeted, they generally get click-through rates of 12-17 per cent, according to the Web portal Yahoo!. Experts suggest that conversion rates like these are highly attractive when compared to the banner advertising market. Also, advertisers pay 30-35 cents for each click. While Overture supplies websites such as MSN and Yahoo!, Google supplies its own website besides catering to associates like AOL.

'Paid inclusion' which has emerged as the second model is, however, controversial. According to experts, advertisers pay to have their websites 'crawled' by an Internet search engine and their information is included in the regular search results, instead of a separate advertising section. Companies like AltaVista which offers paid inclusion products ensure that businesses' websites are included in its index. Overture, which has acquired AltaVista, says that it plans to enhance the latter's

paid inclusion products and offer its advertisers additional high-return marketing vehicles intended to drive targeted customer leads. Several industry experts have expressed concern that the search engine providers might abuse this route to play favoritism to their clients. Providers like AltaVista advise advertisers to write their listings in a way that gives them the best chance of showing up prominence in a search. Critics say that since these service providers alone understand how the algorithms inside their search engine 'black boxes' work, they generally know how to game the system, though it is a power they claim to use responsibly. "Yet the controversy surrounding paid inclusion is dividing the search business," claims *Financial Times*, Britain's influential financial daily. Google, on its part has, however, ruled out to join the paid inclusion service bandwagon, claiming it will destroy the integrity of Internet searches.

Instead, Google concentrates more on content targeting, which it says gives its client advertisers more reach. Experts say that the latest move would play a significant role in deciding Google's penetration in the market. This is important given the fact that although Google has been known for its search engine, it has grown substantially with its 'paid-listing' services that give ads prominent placement among search results and help advertisers closely track campaign results. Advertisers using paid-listing services from Google or Overture bid to place their ads—which look like Web search results and are organized under a heading such as 'sponsored links' at or near the top of the Web-search results screen. Advertisers pay when Internet users click on their paid-listing. The more prominent the placement of paid-listing, the more the advertiser pays per click. Google's current search partners include AOL Time Warner's unit America Online, AskJeeves, Inc. and *Washington Post*.

The search engine giant has already begun serving its content-targeted ads for clients like *Miami Herald* and the *San Jose Mercury News*, and HowStuffWorks.com, as well as for its own online newsgroups. However, industry experts are skeptical that the company's content-targeted paid-listings would generate more clicks than traditional ads. They opine that paid-listings would be more effective with search results as search engine users look for something specific, than Internet content users who may not want to leave a Web page they use at a given moment.

Paid-listings would be more effective with search results as search engine users look for something specific, than Internet content users

The space ahead

Though in its evolutionary stage, search business is probably entering a phase of consolidation, courtesy the dotcom demise which left many early entrants like Inktomi and Infoseek licking their wounds as success deluded them. Now those companies could hope to have a second lease of life with existing players like Google and Overture look to consolidate their position. To quote *Financial Times*, "Companies left on the dotcom scrap heap are being snapped up in preparation for a battle over what is fast becoming one of the hottest new advertising markets." Recently Yahoo! grabbed Inktomi, while Overture, the pioneer of search-related advertising, took over AltaVista in a 140 million cash and stock deal, besides acquiring Fast, the Norwegian company which owne AlltheWeb.com. Walt Disney whose flirt with Internet floppe two years ago with the failure of it search engine, Infoseek, which i also looking for a potential suitor fc the derelict engine. What is addin to the renewed activity in th search space is the emergence c sponsored ads. As says *Financic Times*, "Attaching paid-fo messages to online searches i helping to turn the battere Internet advertising busines back into a growth market. According to the Web porta Yahoo!, the two-year old search advertising business which wa worth about $1 bn in 2002 wi nearly double in size by the end c next year. And, by that time it wi outgrow the more mature onlin jobs market and be worth half a much as the market for mor familiar forms of Interne advertising such as banners.

This might be the force behin recent spate of consolidation i the search business arena However, in the process it i threatening to turn the existin partnerships into rivalries. Tak for example, Overture an Yahoo!. The former collects an serves ads to accompany searche conducted on Yahoo!. Howeve Yahoo! is running its own rival a services in several other markets Analysts opine that given th lucrativeness of the ad-revenu pie, such partnerships could en up into fierce rivalries. But th story does not end here. A *Financial Times* commented Yahoo! Which also relies o Google's search engine to powe enquiries on its own website, th days may be numbered for suc arrangements, given Google' surging popularity and Yahoo!' own acquisition of Inktomi.

Amit Singh Sisodiy

Reference # 1-2003-04-12

APTECH

Betting on Hexaware Technologies!

The acquisition of Aptech Training division by SSI has raised many a eyebrows. After selling off the promotor stake in Aptech, Atul Nishar is now concentrating on Hexaware Technologies.

Aptech Ltd. incorporated as Apple Leasing and Computers Ltd. (a public limited company) in October 1985, underwent certain iterations in its name and has finally settled with its present name. Promoted by Atul K Nishar and family, the firm is engaged in diversified businesses like computer education, software development and consultancy. Aptech Education was demerged as a separate entity and its software division was amalgamated with Hexaware Technologies Ltd., another company promoted by Atul Nishar. While the new entity was renamed Hexaware Technologies (HTL), the training division retained the Aptech brand as it was more synonymous with education. Aptech which is an acknowledged brand in the IT training industry ventured into its software operations focusing on knowledge management, e-commerce and education software. Hexaware is a software services provider that offers powerful process-driven, high-quality, cost-effective solutions that help organizations operate efficiently. The objective of the merger is to provide a better geographical reach and a wider array of IT solutions to its worldwide clientele. 2001 was a year of change for this education and services company.

What made Atul Nishar to move out of Aptech?

The question still remains unanswered in the minds of franchisees, employees and obviously to general public. The fog is yet to be cleared. It is infered that SSI had planned to acquire a significant stake in infotech training major Aptech Ltd. a year back with an intention to integrate its education and training businesses in the merged entity. SSI is working out an interesting merger and acquisition deal with Aptech. The company has acquired 27.18% of promoters' stake in Aptech and will soon be making an open offer for 20% more stake in that IT education company. After acquiring 47% or more control of Aptech, SSI plans to demerge its IT education business and sell that to Aptech, which is a listed company. On February 10, SSI had acquired the 27.18% promoter stake in Aptech.

The purchase of shares through an open offer will increase SSI's holding in Aptech to over 47%, assuming full subscription and acceptance. According to the terms of the open offer, SSI has offered to purchase 3,695,390 shares of Aptech representing 20% of Aptech's paid-up capital of 18,149,437 shares of Rs. 10 each, and potential allotment of 327,510 shares under the ESOP scheme. The offer price is Rs. 49.75 a share. The offer opens on April 3, and closes on May 2. But there are doubts over the SSI-Aptech deal, even as the former is busy acquiring its stake. SSI has clarified that it has not bought the 27% stake from Atul Nishar. It is not known as to how much Nishar actually holds in Aptech.

The logic

Though Nishar is playing a role of passive investor in Aptech, he has to concentrate on its operations as the company plans to consolidate its operations in countries like China, Bangladesh, Vietnam, Nigeria and Columbia to increase its presence, to take advantage of untapped and potential markets and leverage multinational relations to strengthen its base. This restructuring plan definitely needs focus and concentration on the part of Nishar which is acting as a roadblock for Hexaware Technologies. As Hexaware Technologies is now growing very fast and would definitely require hard cash at present in order to invest in the future plans, the all-cash deal will help Nishar to drive the requisite cash by selling off its equity stake in Aptech and bet that amount for the growth of Hexaware Technologies. That clearly indicates the trade-off by him in favor of Hexaware Technologies. Given the enormous promise that Hexaware Technologies is showing as a business, it's a logical move to get out of Aptech and utilize the cash deal for its expansion plan, keeping in mind the long-term prospects.

The existing promoters of Aptech have divested their equity holding in favor of SSI, by which SSI becomes the largest stakeholder in Aptech. It seems that Aptech's promoter group certainly wants to focus only on the software services business, and its decision to opt out shows that it does not want anything to do with the vagaries of the software training business.

Aptech has already penetrated Indian markets so deeply that it cannot expand its centers further.

And at the same time there is a threat of US, Iraq war getting intensified everyday which is having an impact on its domestic and international operations. The current issues complemented with slowdown in IT training industry will definitely curtail future prospects of its business (fresh enrollments). Now, no one is quite sure how long this stagnation will continue. Foreseeing these monsoon clouds it makes sense to get out of this business, which is exactly what Nishar has done.

Making sense

Nishar had stood as guarantor to the loan extended to Apple Credit. Therefore, the Debt Recovery Tribunal (DRT) II has restricted Nishar from transferring or selling his stake in Aptech Training and Hexaware Technologies. With this order, there was a feeling in the market that the sell-off of Nishar's stake in Aptech Training would not be possible and would therefore stall the overall stake sale plans. However, now the promoters other than Nishar are believed to have expressed their willingness to offload their positions. Nevertheless, it turns out that Nishar does not personally hold any of the shares that are being sold to SSI. Nishars family members and other related entities hold these shares, and hence the order by DRT II of Chennai does not pose any problem to the deal. The deal clearly has its positives, since it gives SSI the access to markets such as Western India, where Aptech has a reasonably strong presence. Moreover Aptech's strength in longer-term career development courses will certainly complement SSI's portfolio, which is skewed toward short-term career enhancement courses. Aptech has significant strength in long-term courses and multimedia, whereas SSI is recognized for its strength in short courses in emerging technologies.

Nonetheless, despite the fact that the combined entity will have a better portfolio and a better reach, the fact remains that the domestic software training business continues to be in pretty bad shape. Both SSI's and Aptech's domestic revenues in December fell around 40% and according to SSI's segment results, the company's education division posted an EBIT-level loss of around 8% of sales. This move will definitely prove instrumental for the combined entity to name itself software-training giant. This synergy will enable combined entity to operate as a market leader in the infotech training industry and deliver great value to customers, partners and employees. The Aptech-SSI combine will have 3,208 centers and revenues of over Rs. 420 cr from its present network of 2,499. The story makes sense for SSI but does it make any to Nishar for selling its 24.7% stake to its rivalry? After nurturing the baby for 18 years why would Nishar want his grown-up child to be in the hands of its rival and will the dream be fulfilled. The scene is yet to be witnessed.

The technology and learning industries are growing, but there is a shift in the type of skills that are required

Road ahead...

While the US had been talking about slowdown since early 2000, nobody-either globally or in India dreamt that it would lead to a recession. The first profit warnings were issued only in late October and suddenly, the great IT dreams of an average Indian came tumbling down. This was an end to a party of short-term vertical courses and for small-time fly-by-night operators. Perhaps, their *modus operandi* was to make a quick buck and run. or perhaps they went on a massive nationwide campaign just to build the brand and reap the benefits at their IPO, or perhaps still they were bleeding so bad that they could not continue to survive. Whatever may be the reason, fact of the matter is that such closures—like those of Wintech and Zap—happened at a time when the market had gone bust. The impact—there was overall panic.

The question at top of the mind of most investors is whether the worst is over for the training industry? Before the September 11 attacks, it was believed that the worst was indeed over and the trough of the business cycle had been reached. Now, no one is quite sure how long this stagnation will continue. The consequence would be that the course fees for this segment would either stagnate or dip further.

Overall, even if demand revives it may be a while before the operating profit margin and profit growth of companies are restored The worst, in terms of faltering financial performance, may take a while to bottom out. With the demerger of the Training division of Aptech into the company, the business of training and education (Aptech Training) is receiving focused management attention and the company is poised to take leadership position in the industry. The company feels that it should be on a much stronger footing after this period of consolidation and when the industry revives will forge ahead rapidly with aggressive expansion plans in the days to come. The technology and learning industries are growing, but there is a shift in the type of skills that are required The IT education in the country must move out of the mode where teaching is focused on technology and not on the applications of technology in a domain area. The challenge to training institutes is in creating professionals who are able to apply technology to a domain area and so the knowledge, skills and attitude gained are crucial.

Ajay Hukamichand Shethiya

Reference # 1-2003-04-13

BPL

Liquidity blues

Till recently, BPL was leading the CTV segment but this time around the company prefers to save the resources of promotional expenditure to improve its bottom line.

The cricket World Cup is a period of frenzy in the Indian subcontinent. No event gets bigger coverage and creates more hysteria than this event. So it comes as no surprise that the event marks as the festive season for the advertising industry because—"It doesn't get bigger than this." It is a much-awaited event for all the major companies as it opens the doors to capitalize on the opportunity to enhance their brand equity and push up sales volume. Every World Cup witnesses the ad spends more towards only one direction—north and one sector that enjoys the benefit during this bonanza is the consumer durables sector as it is the biggest promotional event for the sector. With the aggressive entry of MNCs in the past few years, the ad spends are only increasing. Take, for instance, LG which has dominated the consumer durables sector in the past few years, is getting aggressive in garnering market share and has earmarked Rs. 30 cr for the cricket mega event. All the major consumer durable companies in the CTV segment have packaged goodies and signed up celebrities to drive the sales growth. Yet one company, which is conspicuous by its absence, is BPL. The reasons for its absence should come as no surprise to people who have been following the news flowing out of its stable for the last two years. The news has been far from encouraging and in fact today, for BPL it is fight for survival rather than hitting the growth curve, with not just profits plummeting but the all-important cash flows taking a severe hit.

Financials – Gone for a toss

What has gone wrong with the company whose aggressive promotions in the very last World Cup had ensured 10% increase in volumes of its CTV business? Over the last few years this segment has seen a lot of churning and with the entry of Korean and Chinese majors the competition has turned from fierce to cut-throat resulting in aggressive price cuts which the Indian companies are finding it hard to fight. At one time BPL was touted as the only Indian company, which had the brand, market share and financial muscle to take on the global giants. But today, the company with supposedly deep pockets is finding holes and the cash is fast draining out of it. The revenue growth since 2000 has been –14% CAGR and the bottom line has had a growth of –30% CAGR. The ROE of the company has plummeted from 21.18% in 1999-2000 to 6.51% in 2001-02 and the long-term debt to net worth ratio has alarmingly increased from 0.28 in 1999-2000 to 0.80 in 2001-02. Taking the more recent figures into consideration the interest burden for the Q3 of the current fiscal year 2002-03 has increased by a staggering 102% over the corresponding quarter of last year. The GPM had slumped from 12.1% to –4.3% while the NPM has crashed from 3% to –40% for the same comparable periods.

Continued troubles

For the past few years the company is in troubled waters. Factor this:

- In July 2002, CRISIL downgraded the company's debt rating. BPL was charged for misleading CRISIL by disclosing that the company was meeting the debt obligations as per schedule when, in fact, it was already defaulting on its repayments.
- Few months down the line reports were published that the company was exiting some of its key business ventures as it was facing a cash crunch.
- To complicate the matter, BPL was hit by the exit of high profile managerial staff, Anand Narsimhan (Head – Brand Management) and Ajay Baijal (Head – Entertainment Electronics) and George Thomas, the COO.

Income Statement (Rs. cr)

	As on		
	Mar. 31, 02	Mar. 31, 01	Mar 31, 00
Profit & Loss a/c			
Net Sales	1,181.30	1,558.760	1,850.70
Operating Income	1,189.11	1,558.760	1,850.70
OPBDIT	174.25	183 27	207.00
OPBDT	81.67	119.02	144.56
OPBT	41 58	87 11	118 54
Non-Operating Income	0 61	3 03	0.29
Tax	4.30	9.00	11 71
Profit After Tax (PAT)	37.89	81.15	107 12
Cash Profit	77.98	113.05	133.14
Dividend-Equity	0 00	6 92	16.62

Source: www.myiris.com

Perhaps a brief history about the operations of the company would throw some light on the dilapidated state of affairs and why it is fast losing its dominance in the Indian markets.

Since late 1990s BPL has been aggressively investing in various diverse projects such as telecommunications, power, alkaline batteries, acquisition of Uptron picture tube plant etc. While many of these projects have failed to bring in the desired results for the company there were others where the probability of success was worth taking the risk but the gestation periods were high as well which meant it would require long periods to break even. To finance all these projects the company borrowed heavily to the extent that the company's debt went up to Rs. 800 cr for the fiscal year 2001-02 forming almost 50% of its balance sheet size. Obviously, the interest obligations on this debt are the main cash outflows. This coupled with falling market share and revenues has put the net cash flows position of the company in a precarious state. Moreover, the refrigerator and washing machine business have taken a hit with the unleashing of MNC products. The telecommunications business was doing well in certain circles but stiff competition from other biggies and with the mobile tariffs falling, the revenues from this business are also under stress. Further, the cut-throat competition from the WiLL players complicates the BPL telecom business. Last year, it had almost achieved a mega deal when BPL Communications was to be merged with IDEA Cellular creating India's biggest telecom company. This would have translated into a relatively assured source of income. However, the strained relations with its equity investors, did not allow the deal to get through. The valuation which BPL was to get in that deal was far higher than the valuation it would get today if it were to go ahead with the same plan. This means loss of fixed source of income that could have accrued to the company.

According to ORG-GFK, the company has slipped from No. 1 position in the CTV segment to No. 4

All these factors are adversely affecting the main businesses of BPL and it is finding it tough to promote its products which are advertisement-driven. Some newspaper reports suggest that the company intends to exit its non-core businesses. Th probably will help the compar overcome the liquidity crunch th has started affecting its bread ar butter, CTV business. According ORG-GFK (October 2002), tl company has slipped from No. position in the CTV segment to N 4 and looking at the way th company has kept itself away fro promotion during the crick bonanza it looks like even th position is in danger. The financia of BPL do not look all that healtl for the current fiscal 2002-03.

	As on					
As on	Dec. 31, 2002 (Q3)	Sept. 30, 2002 (Q2)	June 30, 2002 (Q1)	March 31, 2002 (Q4)	Dec 31, 2001 (Q3)	Sept. 30, 2001 (Q2)
Total Income	178.81	149.71	211.30	309.56	383.02	329.34
Total Expenses	186.30	147.70	174.73	265.79	336.60	290.84
OPBDIT	-7.49	2.01	36.57	43.77	46.42	38.50
Interest	50.23	50.51	24.50	21.30	24.90	18.48
Depreciation	11.57	11.45	9.51	15.33	8.72	8.78
Profit After Tax	-69.29	-59.95	2.36	5.84	11.50	10.34

Source: www.myris.com, www.indiainfoline.com

Glimpses of hope

However, company officials feel tl worst is over and things can on get better from here. This optimis is primarily because of two thin that are expected to happen in tl next fiscal—the power project Andhra Pradesh is expected reach its financial closure and tl global giant Sanyo is expected pick up stake in BPL's appliance division. However, the news is th the global giant is negotiating for stake in BPL Ltd. These even would bring the company the muc needed cash and take care of tl liquidity crunch that is plaguing tl company. The top tier of BPL working hard to turnaround tl company and has planned a numb of initiatives to put the industri house back on track. The group h appointed M Sashi as the Finan Director who had bee instrumental in the turnaround Uptron picture tube plant.

However, what needs to be see is that, will these initiatives worl The most important determinant BPL's future will be the price which it can divest its stake in tl group companies. Looking at tl current state of affairs and the w the stock markets have bee hammering the stocks, chances getting good valuations to sell i stake look bleak.

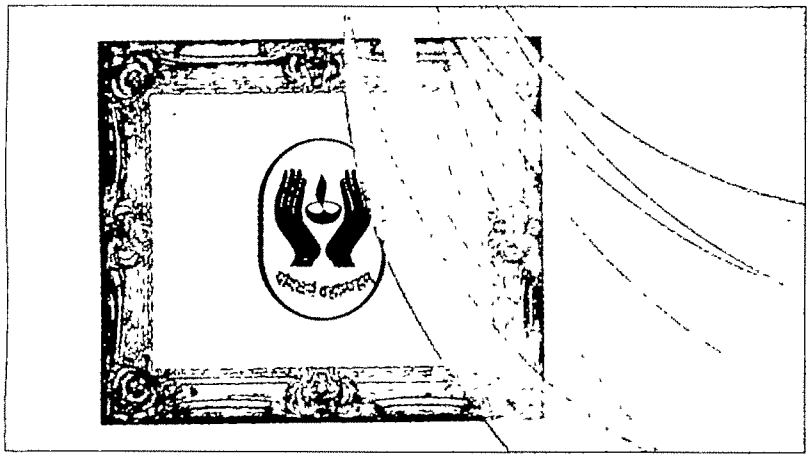
Aniruddha Kekatpu

Reference # 1-2003-04-14

LIC

The changing phase

LIC, the life insurance behemoth in India, has initiated aggressive strategies to retain its position as the market leader.



Having lived in an era of monopoly since 1956, the Life Insurance Corporation of India (LIC) has indeed awakened; to a deregulated environment in which several private players have partnered with multinational insurance giants. LIC became the first company in insurance history to touch the pinnacle of Rs. 15,000 cr in first premium segment, which it did in 2001. But in the subsequent year it had lost 8.6% market share to private players. In an effort to improve itself, LIC is investing in information technology, which is aimed at instantaneous processing of proposals to retain existing clients and lure prospective clients. 'Quality Services, Retain and Build Customers' seems to be the motto of LIC.

Background note

LIC was formed in September 1956 through the 'LIC Act 1956' with a capital of Rs. 5 cr. The main objective of forming LIC was to spread the insurance cover to all segments of society. Over the years, LIC expanded its network and today it has seven zonal offices, 100 divisional offices, 2,048 branch offices and an army of agents totaling 6,28,031.

The changes in the economy in 1980s, such as growth in the rate of industrialization, infrastructure, capital markets, savings rate and capital formation resulted in a tremendous growth in the life insurance industry, which in other words meant growth of LIC. However, need for reforming the industry was felt in the early-1990s for providing better coverage and to increase flow of long-term financial resources to finance the growth of infrastructure. In 1993, the Indian Government constituted the Malhotra Committee to suggest reforms in the industry. And the reforms resulted in privatization of the insurance sector.

Two sides of the coin

With 12 private players in the life insurance sector, the competition for LIC, a public concern, seems to be tough. But LIC still has few competitive advantages. Over the period LIC has built a very powerful brand image. In India, the concept of life insurance is synonymous with LIC. Further, LIC agents have built personal credibility with clients by providing them reliable service over the years. It would take a long time for private players to build such credibility and brand image.

However, LIC has its own drawbacks. The perception of 'poor service providers' is a stigma, which LIC has to fight. And if this image is not rectified soon LIC stands to lose its market share rapidly, since quality of service is an important concern.

LIC's typical strategy has been to employ a large number of marketing people as 'Development Officers' in each branch. These development officers employ and train a number of agents, and in turn receive incentives from business generated by these agents apart from their usual salary. LIC's cost-effectiveness has suffered by paying bonuses and commissions twice—to agents and development officers—for every new policy and every subsequent renewal of premiums. After a few years of agent recruitment, development officers actually collect a large revenue stream in commissions almost effortlessly. In case of private players, they don't follow such marketing strategy.

LIC presented insurance to the clients as a tool for tax incentive and savings rather than as a measure against risk protection. A look at LIC's policy portfolio shows that just about 18% of their policies are protection policies while the savings policies are about 60%. In fact, LIC has been losing ground on pension portfolio, a protection policy, with private players already claiming a market share of 40%. Confirming the issue S B Mathur, Chairman, LIC said, "Although we have a 94% market share in endowment products, certain products like pension are being sold much less

and we are seeing customers moving towards private insurance companies It is time to realize the changes in the marketplace, so that customers can be retained." This lack of varied portfolio leaves an area open to private players to put a dent in LIC's business.

Changing stripes

LIC decided to get its act together and presented a strong reposte to the new players in the deregulated environment. Almost overnight, this public sector behemoth became the epitome of efficiency. For the first time, the corporation has fixed targets such as attaining zero outstanding maturity claims and going in for special campaigns for the revival of lapsed policies. LIC's chairman boasts of an outstanding claim ratio of only 0.67%, which was among the best in the world. He also claimed that LIC topped in settlement of claims worldwide with a speed ratio rate at 90%. Last year, 88 lakh claims had been settled before the due date. which is the highest by international standard.

LIC has also brought down its expenses. Confirms Mathur, "We have to reinforce budgetary control." LIC has brought down overall expenses from 21.16% in 1999-2000 to 13.89% in fiscal 2001. For the fiscal 2003 it has benchmarked to bring down the overall expense ratio to around 17.3% as compared to approximately 17 6% in 2001-2002. It has taken small steps but for a giant like LIC that actually matters. The insurer has installed three-minute disconnectors in the branches restricting all outgoing calls to three minutes, with the exception of the direct telephone line of the branch manager. It has also decided to cut down printing and stationery, travel expenditure as well as rental of real estate. LIC is going to have an open system of performance appraisal for its officers. The new system called the Development Oriented Performance Appraisal (DOPA) would replace the existing closed assessment of its executives. It has also tied up with IIMs for customized training programs for upgrading the manpower skills of its employees.

LIC has taken a lot of e-initiatives to improve the quality of service while bringing down the transaction costs. Its 2,048 branches are to be networked under Metro Area Network (MAN). Once all LIC branches are brought under MAN, the policyholder can remit the premium in any branch. In addition, the policyholder gets his status report, policy position, revival and quotation from the network. Every hour the system gets updated. To make maximum use of technology, LIC has also tied up with Citibank, GTB and Billdesk for the online payment service. Around 15,000 clients have already enrolled for paying online premium. The corporation plans to launch eight call centers to ensure easy contact with the customers.

On a common platform, for rural and urban market, LIC has started using bancassurance channel, in which bank will sell LIC products. It has roped in more than six banks; which includes Corporation Bank, Indian Overseas Bank, Oriental Bank and few other co-operative banks. Further, it has launched products in the last year like *Jeevan Bharti* on Women's Day, *Komal Jeevan* on Children's Day, *Samriddhi*. *Bima Nivesh 2002, Anmol Jeevan* and *Jeevan Anand*. It also plans to go international by launching operations in Sri Lanka, Oman and US. A Ramamurthy, former chairman of LIC, said that it would be targeting the 1.8-million strong NRI community living in US, who earn on an average between $55,000-65,000 per annum and their propensity to save is three times that of an American.

In the urban areas, LIC is experimenting with mobile advertising, using both bus and train and print advertising in local newspaper. For the rural part, it plans to use ITC's newly installed 'e-choupal', an IT-enabled parallel procurement, marketing and distribution network, to sell some of the group insurance policies that have been designed for the landless or marginal farmers. LIC is painting the walls, adapting folklores and merchandising to communicate to people and sell insurance. LIC is tieing up with public sector banks with better reach, indicates its intention to serve rural market. Thus, it remains focused to its social and business cause.

Future foray

LIC has set itself a target of 25% growth by 2005, above the current growth rate of 20%. But it is easier said than done. To achieve the target LIC needs to capitalize on the consumer awareness, which is being done by private players. They need to provide customized solutions because investors are looking forward to integrated financial solutions that can offer stability of returns along with total protection.

The demographic shift coupled with changing socio-economic climate increases demand for insurance in India. Thus, for LIC selling traditional life insurance products like individual, whole life and term will remain popular; sales of new products like single premium, investment-linked, retirement products, variable life and annuity products are also set to rise. LIC needs to come up with new products with changing demand. However, product innovations are quickly and easily cloned. Pricing will also not vary significantly, with most product premiums hovering around a narrow band. Thus, critical success factor is a top-down emphasis on exceeding customer expectations with quality people, excellent products, and legendary service. As it has been seen in other financial services, the entry of private players ensures that customer will be the beneficiary in the long run.

Preet Jajodia

Reference # 1-2003-04-15

Why do Firms Buy-back their Shares?

Firms repurchase their shares to distribute surplus cash and exploit perceived underpricing. What could be the other compelling factors?

Most of the research reveal the fact that the UK market reacts positively to share repurchase agreements. A positive reaction to the repurchase agreements has been documented in other countries as well. A range of theories have been proposed and tested to explain the positive stock market reaction to repurchase announcements. The one explanation that has received considerable attention is the signaling hypothesis. Information asymmetry between the management and the shareholders may result in an undervaluation. If the insider believes that the firm is undervalued they may announce the intention to share repurchase to signal this fact to the market. The market participants interpret share repurchase announcements as evidence that the firm is underpriced thus leading to upward revision of the share price.

Another explanation to the positive stock market reaction to the repurchase plan agreement is the surplus cash hypothesis which is based on the view that the firms' cash resources may exceed the value—increasing investment opportunities available to management. Under such conditions, managers are given incentives to invest surplus cash on perquisites, empire building and other negative net present value projects. Accordingly, shareholders of firms characterized by surplus cash and a poor portfolio of investment opportunities face serious agency problems if management do not distribute this excess cash. Share repurchases provide managers with a means to distribute excess cash to shareholders, thereby reducing the opportunity for wasteful investment and hence increasing firm value. Several additional motives include fending off hostile takeover attempts, avoiding the dilative impact of share options on per share value of outstanding stock and adjusting the firm's capital structure.

The capital structure hypothesis predicts that repurchases are motivated by the desire to maintain an efficient balance sheet

Share repurchases are negatively correlated with share price performance: As prices fall, managers appear to respond by buying more shares. This strategic trading behavior is consistent with the view that firms initiate repurchases when their shares are perceived as being underpriced. In addition to underpricing, several studies present evidence consistent with the prediction that share repurchases are motivated by a desire to distribute surplus capital. There is a positive association between share repurchase and cash flows.

While the surplus cash and underpricing hypotheses are the most prominent explanations in the literature for share repurchase, other motives have also been proposed and tested. The capital structure hypothesis predicts that repurchases are motivated by the desire to maintain an efficient balance sheet. For example, if managers believe that an optimal leverage ratio exists, repurchases may be used by undergeared firms as a means of achieving their target leverage ratio.

Factors that distinguish repurchasers from non-repurchasers

The tests involve comparing open market share repurchasers with sample of non-repurchasing firms. A logistical regression model relating to the probability of an open market share repurchase in time t to measures of underpricing surplus cash, investment opportunities, leverage and a vector of control variables. (see the equation below)

The first variable in the equation NRET is the proxy for underpricing and is defined as one if the market adjusted return measured over the fiscal year prior to the repurchase year/poor returns history is a possible indicator of underpricing. NRET is negatively associated with

$$\Pr(Repurchase)_t = \gamma_1 NRET_{i,t-1} + \gamma_2 MTB_{i,t-1} + \gamma_3 CASH_{i,t-1} + \gamma_4 HILEV_{i,t-1} + \gamma_5 \Delta EPS_{i,t-1} + \gamma_6 LOSS_{i,t-1} + \gamma_7 DIVPAY_{i,t-1} + \gamma_8 SIZE_{i,t-1} + \gamma_9 DIST_{i,t-1}$$

Summarized version of "Why Do Firms Buy-back Their Shares? An Analysis of Open Market Share Reacquisitions by UK Firms" by Dennis Oswald and Steven Young, November 2002.

the likelihood that the firm repurchases its shares.

The second variable MTB is the unlevered market-to-book ratio. It is predicted to be negatively associated with the probability of a share repurchase for several reasons. First, firms with low market-to-book ratios are more likely to be underpriced. Second, to the extent that the market-to-book ratio is negatively correlated with firms' investment opportunities, the agency problems of excess cash are likely to be more acute for low market-to-book firms

The third variable CASH is a direct measure of surplus cash. We define CASH as the ratio of cash and cash equivalents to total assets. The surplus cash hypothesis predicts that CASH will be positively associated with the likelihood of a share repurchase

The fourth variable HILEV, an indicator variable defined as one if leverage is above the median for the pooled sample and zero otherwise. If firms initiate buy-backs when gearing levels undershoot their target leverage ratio, HILEV will be negatively associated with the likelihood of a share repurchase, to control for the negative association between leverage and excess cash. Gearing is the ratio of net debt (debt minus cash and cash equivalents) to non-cash assets.

The fifth variable is increased EPS. This variable is also taken because the firms cite the desire for increase in EPS as the motive for repurchase. The sixth variable LOSS is an indicator variable taking the value of one if previous-year reported earnings are negative and zero otherwise and is intended to proxy for the absence of surplus Advance Corporation Tax (ACT) against which to offset the ACT arising on a share repurchase. All else equal, firms lacking surplus ACT capacity are less likely to initiate a share repurchase because doing so will generate an additional ACT liability. Therefore, it can be predicted that LOSS will be negatively related to the probability of a share repurchase.

The seventh variable dividend payout ratio (DIVPAY) is included to control for the possible interaction between dividends and share repurchases. DIVPAY is defined as dividends paid divided by reported earnings. The sign of the coefficient of DIVPAY is not predicted because if firms view dividends and share repurchases as substitutes, the relation will be negative whereas, if firms use both devices as complimentary distribution mechanisms it will be positive.

The eighth variable firm size (SIZE) is included to control any residual size differences not captured by our matching procedure. SIZE is measured as the natural log of total assets. The final variable DIST is an indicator variable proxying for the existence of distributable reserves. Under the UK company law, firms are only allowed to fund share repurchases out of distributable reserves. DIST is defined as one if total shareholder reserves are positive and zero otherwise and predict that this variable will be positively associated with the probability of a share repurchase.

The reason most frequently cited by UK managers (29% of cases) is the desire to increase earnings per share

Results

The sample size consisted of all the 428 companies in UK which have gone for share repurchase. NRET is positive and significant at 0.001 level as predicted, indicating that repurchasing firms are more likely to underperform their non-repurchasing counterparts over the 12-month period prior to the repurchase year. In contrast, repurchasing firms are statistically indistinguishable from their non-repurchasing counterparts in terms of the market-to-book ratio (MTB). The estimated coefficient on CASH is positive and significant at 0.02 level. This supports the prediction that repurchases are more likely to be used by firms with high cash holdings.

In addition, repurchasing firms are characterized by significantly lower leverage, as indicated by the negative and significant coefficient estimate on the HILEV term. This is consistent with Dittmar's (2000) conjecture that firms use share repurchases to manage their capital structure when the leverage ratio falls below its target level. However, it is also consistent with the increased risk of financial distress preventing highly geared firms from reacquiring their shares.

Conclusion

The reason most frequently cited by UK managers (29% of cases) is the desire to increase earnings per share. Other frequently cited motives such as increasing balance sheet efficiency are equally difficult to decode.

Comparing repurchasing firms with a time-, industry- and size-matched sample of non-repurchasers reveals high cash holdings and poor prior-period share price performance to be the key factors driving the repurchase decision. These findings are consistent with the view that share repurchases are a response to the problems of surplus cash and perceived market underpricing, respectively.

Additional tests reveal that the positive association between cash holdings and the amount spent on share repurchases is stronger for firms with low market-to-book ratios. In contrast to Dittmar (2000), no evidence of a direct association between repurchases and leverage was found.

D Satish

Reference # 1-2003-04-16

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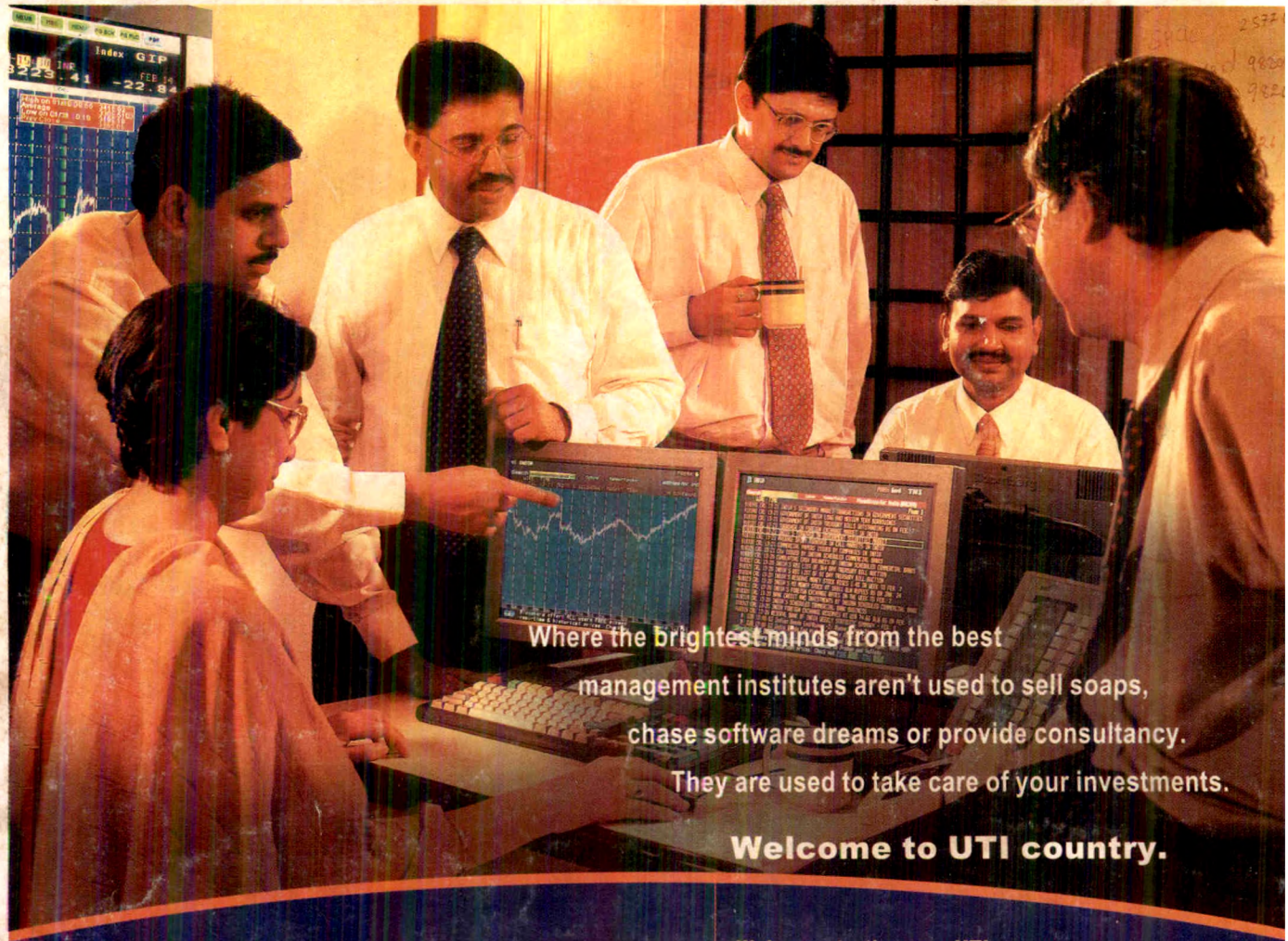

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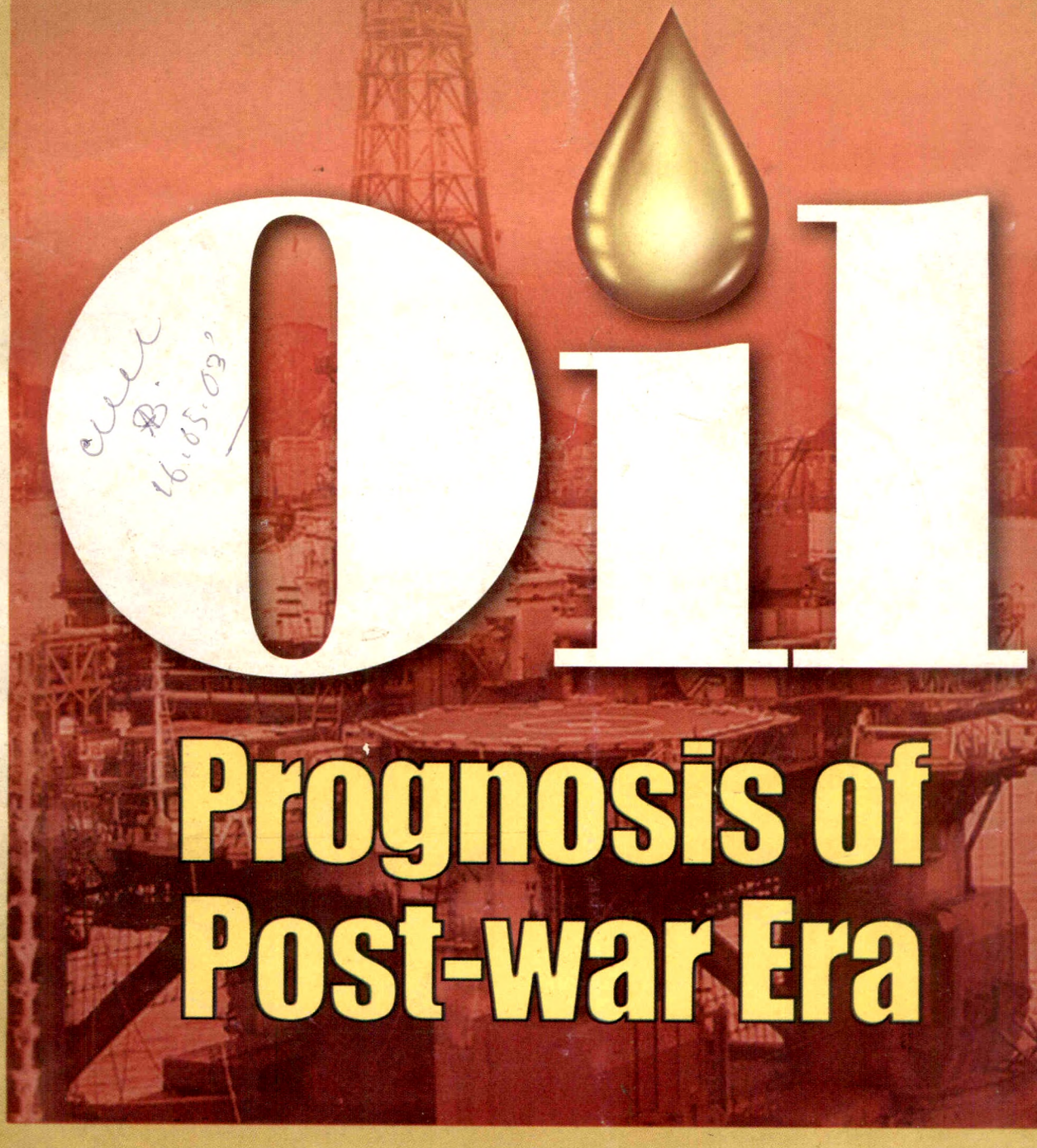

Oil Prognosis of Post-war Era

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Past 1 year	10.56%	10.89%

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The Economics of Oil

The annals of history are replete with instances of wars in the name of religion and politics. Whatever the reasons proclaimed, economic equations have been inextricably intertwined with wars. More so, with the wars fought in the Middle East soil—it being the region producing the bulk of oil for the world economy. In the wake of Gulf War II, doomsayers were predicting oil price scenarios of $50 a barrel. Oil prices have, indeed, risen sharply to around $38 a barrel, reflecting the war-induced fears, but as the war ended, they shed the war premium and settled around $25 a barrel. And the world sighed in relief.

The anxiety over the oil price volatility is a result of the nightmarish experiences of the 1970s when the OPEC—the cartel of a few oil-producing nations, threw the developed economies into a devastating inflationary spiral. In spite of the fact that the world has since learned to cope with vagaries of oil price volatility, and that the OPEC's might no longer being what it used to be, there is a reason to be wary about the possible impact of the Gulf War II on global economy. The reason is the precariously weak condition of the global economy that is struggling to recover from the impact of collapse of the stock market bubble and 9/11.

The economic models suggest that every dollar change in the price of oil has the potential to significantly influence the GDP of the economies, more so in the case of oil guzzlers like US. While the demand side is firmer and is likely to grow, it is the supply side that needs to be looked at. Once sanction-related caps are eased, Iraq can resume oil production to the pre-sanction levels. Experts doubt Iraq's ability to do so, given the poor state of its oil infrastructure and scale of investments and time needed to put them in good shape. It is not yet clear whether Iraq would join the cartel or act independently. There are doubts over the existence of spare capacity in Iraqi oil fields. Whatever course events take, extreme changes in production are unlikely. This leaves price to hover in the region of $20-25 a barrel.

The market for oil has never been a free and fair market. As one expert put it, oil would be available at $3-4 a barrel, if it were a free market. The OPEC members wield enormous power over the supply and use it to charge a staggeringly high premium for oil. Yet, a price level of say $20 a barrel, is now regarded as 'low' price.

Economic theory suggests that cartels represent a failure of the free market system and advise government or regulatory intervention to rescue the markets. If the oil-producing businesses were part of a national economy, antitrust action would have disciplined them long ago, just as it did to Microsoft and others in the past. The fact that non-democratic forms of governments run these nations further complicates the matter.

Since the fears over the oil price spike as a result of prolonged war no longer exist, the concomitant adverse effects of steep price rises on global economy are ruled out. The global economy slowed down long before Uncle Sam went to war with Iraq. The relief stems from the fact that the war has not added further troubles to an already ailing global economy.

Ch Rajeshwer

Letters to the Editor

Congratulations!

China, the powerful neighbor of India has been always appreciated as one of the fastest growing nations over the last decade. It has been dubbed as the largest economy after US. Many a time, India has been criticized for lagging behind China. In this background, the cover story in the April issue of the *Analyst* was very informative depicting the real state of the Chinese economy. It was an interesting as well as an reveling read. Congratulations!

E Madhavi Verma
Pune

Dividend Dilemma

Dividends have often been considered as an important return for shareholders. The article 'Dividends: The new, new thing' brought out the exact extent to which corporate America is used to issuing dividends. The run after capital market gains during the boom era sure had an impact on the demand for dividends.

S A Gopi Kishan
Trichy

Good Job

It was interesting to read the article on McDonald's. I believe many Indians would not have known the inside story of McDonald's. I really enjoyed reading the article. The analysis presented was also very engaging. Good job.

K S Gauri
Chennai

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Cartoon Corner

YOU SAID IT by Laxman

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Verbatim

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– Alan Lacy, CEO, Sears, Roebuck and Co., on the company's revitalization plan

If inflation continues to rise, the soft interest rate regime may be another casualty.

– National Council of Applied Economic Research (NCAER) on Indian economy

We're seeing phenomenal growth again. Somehow it seems like this year's going to be a lot stronger than anybody anticipated.

Philip Murtaugh, Head – China Market, General Motors, on the launch of a new model to boost the company's position in the Chinese car market

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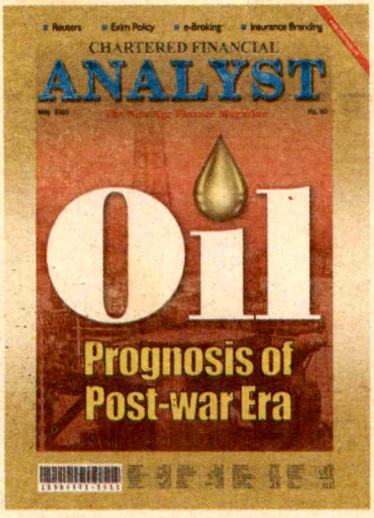

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For nearly three decades, oil prices have been controlled primarily by the oil cartel – OPEC, through the control it has on majority of oil producing countries. That may no longer be the case if America succeeds in its objective of having a major say in Iraq's affairs. Iraq's oil industry is capable of far higher production and could break the Saudi hold on OPEC. A fresh price war among producers is not ruled out because OPEC might be forced to change its policy of defending prices and its market share.

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A misjudged investment in the form of Instinet, zooming competition, obsolete products and services are all now taking their toll on Reuters, making it look incurably ill.

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FORD

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Having taken over the reins of Ford Motor during one of the bleakest periods of its history, Bill Ford has taken some bold initiatives to turnaround the company.

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As a result of poor performance by many mutual funds, investors no longer opt for them. In spite of the market potential, some players are opting to move out of business. This trend is of concern for investors.

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Future of Oil Industry in Iraq

Now that America has been successful in overthrowing Saddam Hussein, Iraq's oil reserves are the center of attention. Who is going to take control of these oil wells, which are still the treasures? The issue is not as simple as it sounds. Due to decades of sanctions all industrial installations are old and many of them rotten. The Iraqi oil industry workers have done an incredible job in maintaining them with the little means they had and are highly commended for this.

The Iraqi National Oil Company was seen to be an efficient organization with high-level professionals. But most installations need replacement and repair and this is likely to cost between €5-10 bn in the coming years, just to get everything working again. Some say even up to €20 bn would be required for the job. Already there are quibblings about who will get the repair-contracts.

At the moment, the war-parties seem first at hand and it looks like they are giving themselves the contracts. Who then pays for them and where is the money retrieved from is another matter. It is obvious that US is doing so via USAID and therefore outside the rules of the WTO and of international tender rules. US is trying to get back the money from future production as collateral. However, this seems to face some problems at the moment.

Further, about 90% of Iraq is not or hardly explored and here many nice surprises are seen to be waiting. Here again the complicated issues are: Who owns the reserves? Who has the right to make the contracts? What is the legal situation? What are the legal parties involved? Who can give out concessions? What legal and tax regime is at hand? And so many more questions. This is what is being talked about, politicized about at the moment, because it involves huge amount of money and revenues to be extracted.

All these questions can be answered only if a more stable, internationally recognized, legal regime is established in Iraq that can hand out contracts that have the chance to survive in the coming years. Until that time not so much will happen, apart from maybe some sensational big contracts. But many of the larger oil companies are cautious because of the insecured legal situation and because they do not want to be put in the corner of "You see, they only did it for the oil, and big oil was behind it."

The price-spikes were almost purely speculative. Increasing world demand is easily covered by the growing production across the world. Much lower prices are not expected as OPEC, and most other producers, will try to prevent the production.

N Janardhan Rao

Reuters: Reversal of Fortunes?

The global downturn is taking toll. Many industries are going through one of the worst phases in recent history. However, the worst victims of this downturn are those companies as well as industries that have done extremely well during the boom in the 1990s. The super-charged equity markets and the sky rocketing share prices ensured that businesses such as investment banking, asset management had very prosperous years. Financial information providers who fed these industries with valuable real time information had also benefitted from the buoyancy of the markets. But the party ended when the Internet bubble finally burst. And the spiraling downturn of stock prices took down with it the prospects of the industries it had supported.

Faltered strategy

Reuters, once the industry leader in financial information providers has recently reported the biggest loss ever in its 150-year-old history. Its share price fell by around 70% in the last one year. Investors are wary and are demanding change of the CEO. One of the main reasons for the poor performance is the bear market. The investment banks and financial institutions, which were its main customers, are themselves going through a bad phase axing jobs at all levels. In such a situation they would not spend huge sums on maintaining expensive Reuters terminals.

Misguided strategy is another contributing factor. A major chunk of loss reported by Reuters stems from Instinet, an Electronic Stock Trading network, which was floated by Reuters in 2001. Many now question the logic of the deal and with investor confidences at one of the lowest ebb, Instinet is far away from break-even. Reuters has also lost out to competition. Reuters which was once the dominant player in the financial information industry has lost its market share to Bloomberg and other lesser rivals. Competitors undercut Reuters by providing the same information at lesser prices via the Internet. Reuters has to take a hard look at the value addition it is providing to its customers in such a scenario.

Tom Glocer, the CEO has implemented a five-year, five-point plan called 'Fast Forward'. The plan addresses the problems of Reuters on both the cost front and in terms of product development. The strategy attempts to take advantage of Reuters' strengths to put the company back on track. It focuses on building on core competencies and utilizing the global reach of the company.

However, time is running out. Disillusioned shareholders are in no mood to give the company much chance.

D G Prasuna

E-Broking: Innovating to Succeed

A couple of years ago when discount brokers like Charles Schwab, E*Trade, and Ameritrade emerged on the scene, offering online investing to millions of investors, they posed serious threat to traditional, offline brokerage firms. This new breed of brokers offered investors a multitude of advantages—lower brokerage charges, fast execution of the buy/sell order, less amount of paperwork, and added to it, the convenience of trading from the place of one's choice—office, home, or from anywhere. In a way, this gave investors a lot of 'freedom' to indulge in stock investing the way they liked. Anytime access to online brokerages also ensured that investors don't have to wait till the next day to place buy/sell orders. All these factors popularized online investing, which saw average online trades per day surge to a record high of 8,00,000 in 1999. However, as it happens with any nascent product/services, the period of high margins during booming days attracted many new entrants. The ensuing price war among the online brokers led to sharp fall in margins, this left them with the choice of either expanding client base or diversifying into other businesses.

Today, as the markets continue to reel under selling pressure, and as the bearish sentiment persists, discount brokers find it difficult to sustain their growth recorded during the heady days of late 1990s. And as the sense of gloom pervades across the business segments, there seems to be no escape from tough times. The grim situation faced by online brokerage business very closely resembles that of consumer foods/retailing businesses. They better look at Wal-Mart to find a solution to their current woe. While its peers like McDonald's and Home Depot are struggling to cope with the slowdown in consumer demand and fall in customer base, the world's No. 1 retailer stands tall, as it continues to improve its profitability as well as market share. On the other hand, both McDonald's and Home Depot continue to lose market share. What makes Wal-Mart to roll on, almost unfazed? The retailing major's strategy is two-pronged—innovate and improvize. While, on the one hand, the company continues to woo customers with innovative concepts like Sam's Club and the Supercenters, on the other hand, it continues to chart the path to improve and expand. While McDonald's struggled to face with a saturated market, as it seem to have overpopulated the markets around the globe, Wal-Mart which faced market saturation in its core business came up with successful variations on its discount model. Online discount brokerage could take a leaf or two out of the world's most successful retailing company.

Amit Singh Sisodiya

Dollar: Sustaining Value

Dollar which has been dominating the global financial environment for more than three decades is experiencing a slight depreciation. Though appreciation and depreciation are common for any currency, the depreciation of the dollar is a surprise to many. Since the 1980s, the dollar has been appreciating vis-à-vis other currencies backed by its ever growing exports and attractiveness of US as an investment avenue.

While there are many reasons that can be attributed to the depreciation of dollar, prominent among them are swelling US trade gap, gloomy economic environment, war with Iraq and falling investor confidence in US markets which was triggered by the combination of corporate distress, accounting malpractices, investment bank impropriety, corporate governance and other geopolitical considerations. However, economists feel that US trade gap may not be a major catalyst as from 1998 to 2001, US trade deficit worsened from -2.5% to -4.5%. During the same period, the dollar ascended to 15-year high. The depreciation of the dollar also indicates a possible slip in confidence in US economy. US has been the most sought after investment destination both for its deep and broad markets and stringent regulations. In the wake of the current developments, many expected that the foreign investors would exit from US. However, the foreign investors are in a dilemma as there is no other alternative available. If the choice of the investors is to exit US on the basis of economic conditions, then the scenario is no different in Japan or UK as both are on the same plain as US.

According to some experts the depreciation of the dollar can be a temporary phenomena if the confidence in the US markets regains. Along with that the slight signals of US economy recovering ahead of Europe will enable the resurgence of dollar. As feared by economists, a prolonged decline in dollar can happen only if US stocks continue their downward slide. Also, there is a strong argument that the dollar will not depreciate further. Since there are only four major currencies around the world (dollar, euro, yen, sterling), the players will not allow large relative movements of any of these currencies. For example, if the dollar depreciates relative to other major currencies, then the other currencies will appreciate. This would place exporters with costs in these currencies at a competitive disadvantage. Hence, the exporters will force their governments to maintain valuation levels. Additionally, as long as dollar-denominated assets remain in demand, further depreciation of dollar may not be possible. As the synchronized worldwide recession gains momentum, wealth holders will seek a safer haven.

Y Chandra Sekhar

NATIONAL

Wipro's Q4 net slips

Wipro's net profit slips by 5% for this quarter ended March 2003.

The revenue base of India's third largest exporter of software services had a net profit of Rs. 225 cr and a revenue base of Rs. 1,238 cr. The fall came in just after the great fall of Infosys last week, which brought the sensex to its all time low. On the other hand, India's richest man and Wipro's Chairman Azim Premji had told at a press conference that 2002-03 was a great year for Wipro with a lot of initiatives like Spectra Mind's acquisitions, and the takeover of R&D Labs of Erickson. Though Wipro has profited from recent influx of outsourcing facilities into India, still shares have stooped down to a low of 39% in the Mumbai's Infotech index. The fall of results was suggested due to the loss occurred in the energies and utilities consulting division of Wipro Technologies which was acquired from the AMS Inc. of the US.

Nine Indian companies in *Forbes* list

Forbes announced the nine Indian companies to list in finest large companies in the world in its recent survey. On the other hand, in 2002, 13 Indian companies were listed in the *Forbes* list of best of small companies in the world. India had a larger number of companies than any other country in Asia to list its companies in *Forbes* list. The nine Indian companies included in the A-list were Indian Oil, Bharat Petroleum, State Bank of India, Reliance Industries, Hindustan Petroleum, ONGC, Hindustan Lever, Wipro and Infosys Technologies. ONGC was ranked the highest in terms of market capitalization and IOC was ranked 56th in terms of sales with revenues of $23,288 mn. In order to qualify for an entry into *Forbes* list, a company must have had an annual sales of at least $5 bn in its latest reported financial year or a market value of $5 bn or more in mid-March. Sales growth, earnings growth and return on capital, analysts' expectations for per-share earnings growth in the current financial year and stock-price performance over the previous 52 weeks were five of the criteria used to rank the companies. On the other hand, Cognizant Technology Solutions Corporation, a provider of customs software development, integration and maintenance services, topped the *Forbes* list of the 25 fastest growing technology companies.

HLL posts 8% net increase in profit

The FMCG major HLL posted a 8.22% increase in its net profit for this quarter-ended March 31, 2003. The net profit figure is Rs. 382.92 in this quarter as against Rs. 353.82 in the last fiscal. Net sales for the quarter increased by 1.2% to Rs. 2,367.50 cr for the company. The consumer goods giant's strategy of focusing on power brands is working for it well. The HPC segment's power brands posted a net increase of 8%. The major boosters were the Hindustan Lever's Home and Personal Care (HPC) segment whose business now stands at Rs. 1,520 cr.

The personal wash business grew by 9% because of brands like Pears and Lifebuoy. HLL seems to be continuing with its strategy of focusing on margins in its foods business. Sales from the foods business was marginally higher at Rs. 1,67.4 cr from the previous period's of Rs. 162 cr while the net loss was Rs. 5.2 cr against Rs. 5.8 cr in the previous period. The processed foods business grew by 18%, driven entirely by a 26% rise in the sales of the Annapurna atta brand.

Infosys under SEBI's guidance

Infosys, the company which laid strong emphasis on quality, work ethics, and excellence went down last week. On Thursday last week, the Infosys scrip had crashed by 27% to Rs. 3,045, a fall of over Rs. 1,000 in a single day.

The software star announced its disturbing forecast of 11% growth in bottom line for the current fiscal. And with it brought sensex to its all time low of below 3,000 mark. SEBI has taken the initiative to find out the reasons for the recent slump in profits of the IT major. SEBI had already started working on finding out the details about the places where major selling activities were in progress for the past one week. The Finance Ministry too has taken initiatives to employ SEBI to probe into the Infosys stock slump. Recent news states that major sellers were the hedge funds at many places, so the regulator can very well look into the unusual fluctuation in the scrip and can independently verify the scrip. The market expectations of 18% increase in results was put down when 11% increase was stated; the stock being a major pillar for other technology stocks brought down other stocks as well.

INTERNATIONAL

Ahold under probe

The grocery major is under the Dutch prosecutors, due to allegations on irregularities in its accounts. It was reported that it tried to mislead its auditors. The group's former chief financial officer Michiel Meurs and Chief Finance Executive Cees van der Hoeven were facing certain charges of irregularities which might affect the future prospects in terms of profits. The documents showing that there was a joint venture in the ICA supermarket in Scandinavia was actually a fraud. By showing the wrong statements the company had gained in revenues by several billion in three years. Securities Exchange Commission, Justice Department and the Dutch justice officials too are in the process of doing an inquiry on the documents and inquiries too are in the pipeline. Ahold's earnings at US Food Service were overstated by more than $500 mn. At the same time Ahold also launched investigations into accounting issues at Disco, an Argentine subsidiary, and its joint ventures.

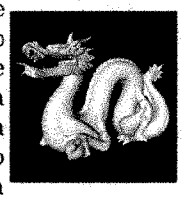
American Airlines: Out of danger

American Airlines was saved from bankruptcy charges after 52% of the workers union voted in favor of wage cuts which comprises of 10,761 members and around 9,652 members voted against the decision. About $1.8 bn would be saved by the airlines due to the wage concessions and avert the Chapter 11 of bankruptcy filing for now.

The wage cuts would bring in sufficient funds for restructuring. The wage cuts include the reduction in concessions available to pilots and the ground staff, which were endorsed by vote. Due to this voting in favor of the company, a lot of spending on the other concerns would reduce. The company has silver lining in the form of voting. Still the company's unsecured debt levels are high and the Fitch had given CCC+ ratings.

The high lease adjusted debt levels increased largely from $17 bn in 2000 to $27 bn in 2002. Though the decision favored American Airlines, still there were rumors that lot of lobbying was done by the top level management and executives to force the flight attendants to vote whereas the Association of Professional Flight Attendants states that the members should vote without any interference from outside. This might affect the labor relations in future if further wage cuts are needed.

China's continuing growth



Even as the world tries to tackle the pressures of a recession, China is continuing to grow at a tremendous pace. Chinese economy expanded at an annual 9.9% during the first three months of this year, according to official figures. The strong growth—China's fastest in six years—was due to a combination of surging investment and domestic consumption. But the National Bureau of Statistics warned that there were still underlying problems, mainly in the uneven way that wealth is spreading around the country, leading to wide variations in standards of living. It also said that the pneumonia-like SARS virus was certain to have an impact, though not a large one, on growth.

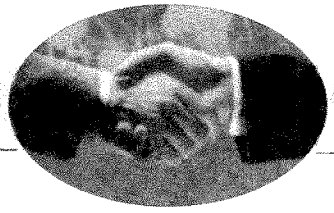
The first-quarter growth figures was well above the government's target of 7% for the year, and exceeds the 8% growth recorded in 2002. Until recently, policy makers have been concerned that China's high growth was not solidly based in economic activity, representing instead potentially unsustainable growth in demand for consumer goods. But the bureau now says that fixed asset investment—money poured into infrastructure, factories and homes—was up by 27.8% year on year. Retail sales, meanwhile, rose 9.2%, amid strong sales of cars, homes, appliances and electronics such as mobile phones. Many analysts expect Chinese economic growth to slow, as a weak global economy saps demand for China's exports.

WorldCom ex-chief under charges

Former WorldCom chief financial officer Scot Sullivan has been accused of accounting malfeasance to secure $4.5 bn in credit for the company. The largest fraud in the US was recorded during his time in Mississippi WorldCom worth $9 bn relating to a fraud in accounting journals. Sullivan is facing new charges on bank fraud and false statements and he might very well add 120 years more to his potential sentence and the concerned new charges were relating to showing false statements and getting loans from banks such as Chase Manhattan, Bank of America, and Citibank.

B Sirisha

Deal Corner



Merger and acquisitions activity has posted quite a decent recovery after the major fall in February 2003. The month of March in 2003 witnessed 100 M&As amounting to Rs. 1,721 cr. And the average value per acquisition deal has crossed Rs. 20 cr, which stood at Rs. 14.42 cr in February 2003. For the fiscal year 2002-03, a total of 1,173 M&A deals aggregating Rs. 23,113 cr were announced as against 1,367 deals worth Rs. 35,086 cr in 2001-02.

Trends in M&A deals

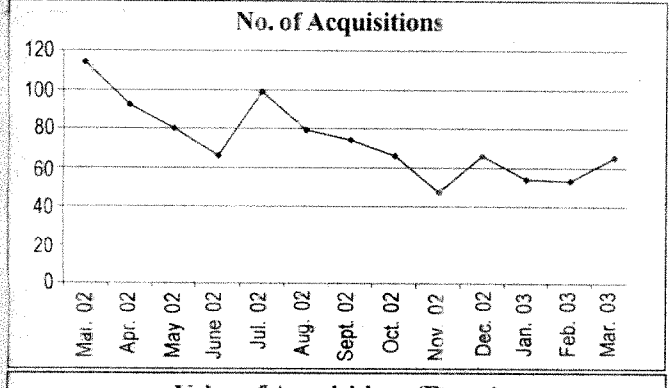
After the major downturn in February 2003 M&As have picked up quite fast in the last month with 100 deals aggregating Rs. 1,721 cr. The major activity was witnessed in Indian mutual fund industry. HDFC Asset Management Company reached the number two position in mutual fund market with the acquisition of Zurich Asset Management India Pvt. Ltd. The merged entity would take the position of ICICI Asset Management Company from its position with an asset base of Rs. 11,000 cr. The major announcement of the MRPL's preferential allotments of shares in MRPL to ONGC was approved this month. In the coming fiscal 2003-04 it is expected that major disinvestment of National Aluminum Co., HPCL, BPCL, and Maruti Udyog Ltd. will yield between Rs. 8,000 cr to Rs. 11,000 cr.

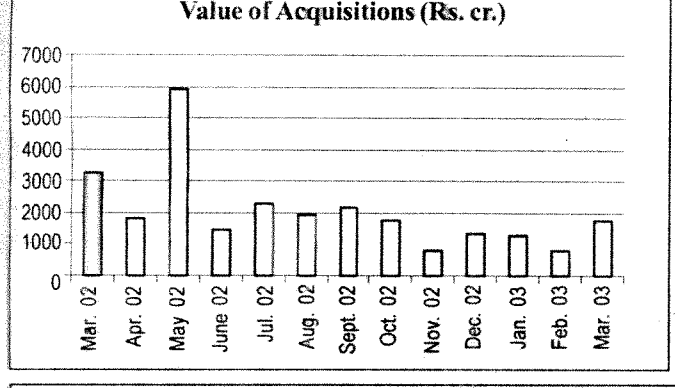
Month	Industry*	No. of Deals	Corresponding Value (in cr.)
Mar. 02	Financial services	20	599
Apr. 02	Chemicals and plastics	16	342
May 02	Chemicals and plastics	11	2860
June 02	Chemicals &	9	186
	Financial services	9	369
July 02	Electronics	22	89
Aug. 02	Electronics	13	977
Sep. 02	Chemicals	12	279
Oct. 02	Chemicals	14	274
	Chemicals and plastics	14	274
Nov. 02	Electronics	11	48
Dec. 02	Financial services	8	54
Jan. 03	Financial services	7	135
Feb. 03	Electronics	15	73
Mar. 03	Financial services	13	308

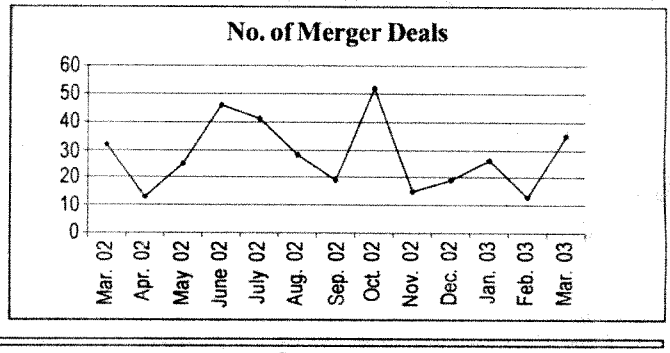
*Month-wise topper in terms of number of acquisitions.

Month	Industry*	Value (in cr.)	Corresponding No. of Deals
Mar. 02	Chemicals	560	2
Apr. 02	Non ferrous metals	475	3
May 02	Chemicals	2860	11
June 02	Electricity	481	4
July 02	Financial services	265	10
Aug. 02	Electronics	977	13
Sep. 02	Financial services	1320	4
Oct. 02	Diversified	945	1
Nov. 02	Chemicals and plastics	319	7
Dec. 02	Electricity	743	1
Jan. 03	Transport and communication	367	6
Feb. 03	Financial services	182	6
Mar. 03	Chemicals	992	9

*Month-wise topper in terms of value of acquisitions.







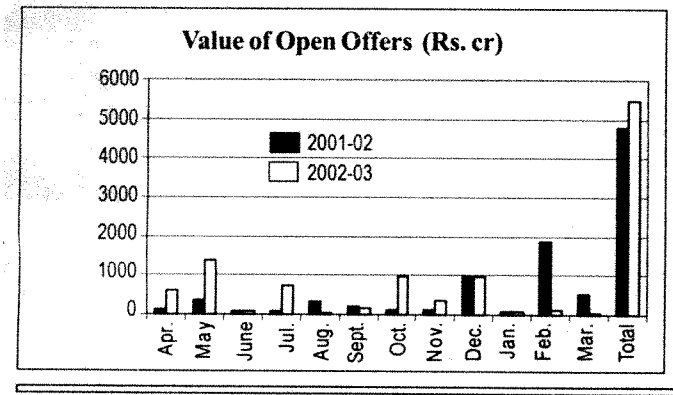
Open Offers

The number of open offers in 2002-03 have increased to 88 in contrast to 81 in 2001-02. This is the fifth year in which the number of open offers are witnessing an increase. Open offers aggregated, in value terms to Rs. 5,464.7 in 2002-03 as against Rs. 490.8 in 2001-02. The main reason why the number of open offers increased despite the poor M&A environment was due to government's disinvestment program where sizeable chunk of government stake in three listed companies like VSNL, IBP, and Hindustan Zinc were sold. The subsequent open offers for another 20% stake in these companies by the acquirers account for nearly 25% of the aggregate value of open offers in 2002-03.

Electronic equipment major Yokogawa Blue Star was acquired by Yokogawa Electric Corporation, offer opening on March 29, 2003. Other open offers, which came into effect, were general-purpose machinery company Vickers Systems International and the acquirer was Eaton Hydraulics Inc. and the offer opens on May 7, 2003.

No. of Open Offers					
	1998-99	1999-00	2000-01	2001-02	2002-03
April	8	10	6	6	16
May	8	7	9	7	12
June	8	2	2	4	5
July	2	4	2	10	9
August	5	4	6	10	4
September	7	3	6	7	8
October	5	6	10	5	11
November	3	5	2	10	12
December	4	18	10	10	14
January	11	6	5	10	8
February	1	13	3	10	6
March	7	11	15	10	4
Total	69	89	76	99	109

On the other hand, Eicher Goodearth has acquired Eicher, the tractor-making group. The offer was priced at Rs. 30 per share. In the dairy products segment the Kwality Dairy (India) has been acquired by Gulshan Dhingra and Others, the offer closed on March 12, 2003 at a price of Rs. 2.75.



Value of Open Offers (Rs. cr)					
Month	1998-99	1999-00	2000-01	2001-02	2002-03
April	97.0	9.5	38.2	112.6	595.5
May	793.9	138.3	660.8	351.9	1,377.0
June	54.8	11.1	0.6	72.4	76.1
July	22.2	50.4	58.6	63.1	725.4
August	56.4	4.4	2.0	335.4	23.8
September	50.9	14.6	22.3	205.1	147.4
October	22.1	14.6	199.9	110.3	964.1
November	7.0	47.7	43.2	128.2	381.8
December	10.4	138.1	1,047.4	963.6	954.8
January	194.5	38.9	18.7	66.2	66.6
February	0.3	8.5	46.6	1,855.6	130.1
March	17.2	276.2	487.3	526.5	20.4
Total	1,326.7	752.3	2,625.6	4,790.8	5,464.7

Substantial acquisition of equity stakes in companies

One of the highlights of the March month in 2003 was the catapulting of HDFC Asset Management Company to 2nd position in terms of assets under management after only Unit Trust of India. UTI is still the major shareholder in the Indian mutual fund industry having a market share of 37% overall. Another major acquisition was of MRPL's by ONGC through preferential allotment on March 28, 2003. ONGC has thus finally taken control of 51% stake in MRPL. Tata Elixi which is the product design arm of Tata group has been taken over by Tata Sons. The acquisition percentage is 18.98. Even there has been talks on putting together all the Tata group companies in technology sector under one head that is headed by TCS. The group companies include CMC, Tata Technologies and Tata Infotech. IDBI Principal Asset Management group will become the wholly-owned subsidiary of US-based Principal Financial group. The group also wants to form a joint venture with PNB AMC. On the other hand, RABO India Finance Pvt. has become the 100% subsidiary of the Cooperative Centrale Raiffeissen, part of Rabobank International group. UTI Bank has allowed for its preferential allotment worth Rs. 164 cr and the shares would be allotted to LIC, Karur Vysya Bank, and Chrys Capital I LLC of Mauritius and to Citicorp Banking Corporation of Bahrain.

Buy-back

The buy-back of pharmaceutical major Abbott India concluded finally on March 14, 2003. The earning price per share before buy-back was Rs. 34.81 and after buy-back was Rs. 36.45. Indian Hume Pipe Co. buy-back offer commenced finally from March 3, 2003. SEBI has given the clearance for this offer on January 14, 2003. The offer targets 25% of the equity capital of the company at a price of Rs. 700 per share aggregating to Rs. 6.78 cr. The price is at a significant discount to the per share book value of the company of Rs. 1,164.74.

B Sirisha

EXIM POLICY

Cementing growth

The exim policy seems to have put India on the right track to achieve the magical one percent global trade by 2007.

India's dream of achieving one percent share of the global exports by 2007 would be a reality if one were to go by the reviews and opinions of the various confederations and industry experts after the exim policy 2003 was announced by the honorable Minister for Commerce and Industry, Arun Jaitley. So, what are the highlights and implications of the policy to various industries concerned and how does it facilitate India to achieve the target set for 2007.

The principal thrust of the policy is to give impetus to exports. The export growth would be accelerated by finding and focusing on the supporting engines of growth—which include the service sector, agriculture and allied products and the electronic hardware sector. Apart from focusing directly on these growth boosters the government has taken special notice on the state of the infrastructure and has laid special emphasis on improving it to global standards.

The government's efforts on development of infrastructure especially in the export clusters would go a long way to enhance the competitiveness in exports. The technological and productivity gaps in these clusters have been identified and 10 more clusters with high growth potential would be identified and reinvigorated.

In another significant move to extend the benefits beyond the Special Economic Zones (SEZs) the government is planning to treat the sales from Domestic Tariff Area (DTA) to SEZs as exports. Domestic suppliers would now be eligible for Drawback and Duty Entitlement Pass Book (DEPB) benefits, service tax and central sales tax exemptions. This would encourage foreign direct investments and exports through these schemes.

The time taken to clear a proposal and the transaction costs is one of the highest in the competing world and it can well be done away with. The government is also emphasizing on procedural simplification, which would result in saving time and transaction costs. High priority is given to issuance of approvals online to exporters. To encourage applications electronically the processing fees would be 50% that of the manual route. The government has also taken steps to simplify the procedure and formalities in the Software Technology Park to facilitate free movement of laptop. Computers and other equipment provide flexibility to the software professionals.

Agriculture and allied products

Agricultural exports were once on top of the list of foreign exchange revenue generators. But for the last decade it seems to be put on the back burner. The government seemed to have noticed that foreign investment in agriculture is crucial to pop-up the exports. In order to give a push to the agricultural exports the policy allows corporates with proven credentials to sponsor Agriculture Export Zone. These corporates would be allowed to provide services like pre-harvest and post-harvest treatment and operations, plant protection, processing, storage and other related R&D. To provide the corporates with international facilities consultations are on with the Reserve Bank and the Finance Ministry for a suitable fiscal package for offshore banking units in these zones. The agriculture processing SEZ units will also be eligible to provide inputs and outputs to contract farmers to promote production of goods as per the requirement of importing countries. This is expected to integrate the production and processing and help in promoting SEZs specializing in agro exports.

In line with the WTO commitments Quantitative Restrictions on import of 69 items covering animal products, vegetables, spices, antibiotics and films have been lifted. Similarly, the Quantitative Restrictions of export of five items—paddy, cotton linter, rare earth, silk cocoons and family planning devices have been removed. This would contribute immensely to the growth of exports.

Removal of restrictions on export of paddy is a very significant factor with wide range of implications. It means that Indian rice farmers can finally sell their produce in the competitive markets to the highest bidder, whether it is the international trader or local rice miller or FCI. Paddy forms a very important part of international trade because the grain can be stored for longer duration. Indian rice exporters can now benefit as it is more cost-effective for them to set up rice mills abroad for processing Indian paddy if domestic tax laws do not allow sufficient returns on value additions. Till now no one could export paddy as the government believed it was crucial to encourage only value-added products.

Electronic hardware

The government has given a boost to the electronic hardware industry. The policy makes it clear

that the supplies of all 217 electronic hardware items from EHTP (Electronic Hardware Technology Park) to DTA (Domestic Tariff Area) qualify for fulfillment of export obligation. To promote the growth of embedded software, hardware would be admissible for duty-free import for testing and developmental purposes. This would make India a player in the world of embedded software. The decision providing 100% depreciation for computers and computer peripherals was a step in the right direction.

Engineering industry

For a change the engineering goods industry especially the auto parts and machine tools industry is likely to benefit from the policy. The most significant move was the removal of restriction on export of warranty spares. The decision to allow duty-free import of second-hand machinery up to 10-year period was also welcomed. This would help to upgrade technology and improve production efficiency especially in the small-scale industry. The government has also decided to continue with the DEPB (Duty Entitlement Pass Book) till 2005 for exporters in addition to offering from taxes to domestic producers supplying raw materials to SEZ (Special Economic Zones).

Hotel and tourism

At a time when recession is prevalent everywhere and the threat of terrorism has adversely affected the tourism industry the government has taken an important decision, which could act as a lifeline for the tourism and hotel industry. The government has taken a specific decision to allow hotels of three star and above to import raw materials consumable and spares up to 5% of the average forex earnings of the previous three years. This entitlement can be used for import of office equipment, professional equipment, spares and consumables. The hotels can now sell duty-free liquor at their bars against 5% of their earnings.

Exim Policy and the Special Economic Zones Scheme

- Agriculture/Horticulture processing SEZ units will now be allowed to provide inputs and equipments to contract farmers in DTA to promote production of goods as per the requirement of importing countries. This is expected to integrate the production and processing and help in promoting SEZs specializing in agro exports.
- Sales from Domestic Tariff Area (DTA) to SEZs to be treated as export. This would now entitle domestic suppliers to Drawback/ DEPB benefits, CST and Service Tax exemption.
- Foreign bound passengers will now be allowed to take goods from SEZs to promote trade, tourism and exports.
- Domestic sales by SEZ units will now be exempted from SAD.
- Restriction of one year period for remittance of export proceeds removed for SEZ units.
- Netting of export permitted for SEZ unit, provided it is between same exporter and importer over a period of 12 months.
- SEZ units permitted to take jobwork abroad and exports goods from there only.
- SEZ units can capitalize import payables.
- Wastage for subcontracting/exchange by gem and jewelry units in transactions between SEZ and DTA will now be allowed.
- Export/import of all products through post parcel/courier by SEZ units will now be allowed.
- The value of capital goods imported by SEZ units will now be amortized uniformly over 10 years.
- SEZ units will now be allowed to sell all products including gems and jewelry through exhibitions and duty-free shops or shops set up abroad.
- Goods required for operation and maintenance of SEZ units will now be allowed duty-free.

On the flip side

On the other side, the Federation of Indian Export Organization regretted that while the policy laid emphasis of Special Economic Zones nothing was done on the exporting units functioning on the domestic tariff. It is interesting to note that these units account for more than 70% of the total exports and employ 75% labor using around 75% of the indigenous inputs in producing their export output.

The Finance Ministry is also set to lose around Rs. 33,000 cr in 2003-2004 on account of incentives given to exporters under various export promotion schemes. This is a 32% jump in the revenue foregone in 2002-2003, which stood at Rs. 25,000 cr.

While policy decisions have been taken the question of implementation and monitoring still remains. It may not be all that easy to implement the measure as there is no customs check on export of services which do not cross conventional customs borders. Perhaps, the banks will have to do the job of the customs superintendent. It will take some time for the measures to settle down.

The exim policy is truly a proactive one and it shows the government's commitment to reach the set target. But India needs to do a lot to be a major global trader. Perhaps, it closely observes the success story of its neighbor China which has become a global player through a lot of determined steps. The model adopted by China promoting its SEZs as powerhouses of global trade is there for the rest of the world to see and replicate.

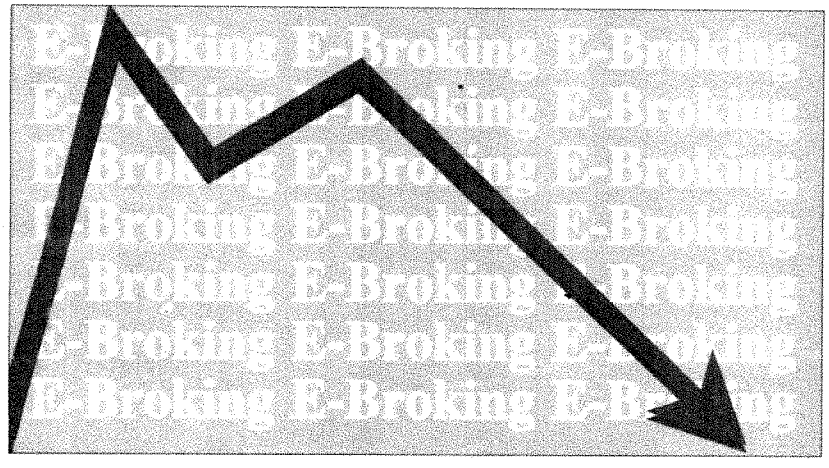
D Satish

Reference # 1-2003-05-01

E-BROKING

Whither day traders?

With the bearish trend continuing to cast a shadow over recovery in the US stock markets and retail investors reluctant to invest in stocks, online brokerage firms face a grim prospect.



It was not long back when online trading along with e-mail and search had become one of the most popular usages of the Internet. The trend was visible more so in the US. The tech boom, which led the bull run of the 1990s, saw the proliferation of hundreds of brokerage sites offering online trading to investors. It was a time when day trading was name of the game that helped popularize online investing. Led by a surge in the number of day traders, representing those investors who buy and sell during the same day, trading volumes touched record highs; the average number of online trades per day, reached 8,00,000 during 1999 in the US. However, such volumes were too high to be sustained for long, which some experts had doubted at that time and what is being exactly realized now.

With the stock markets still reeling under a bearish trend for the last three years in succession, all major online brokerages are facing a slowdown in the trading activity as more and more investors shy away from investing in stocks. With no signs of improvement in market sentiment amidst a weak economic outlook globally, retail investors have increasingly become reluctant to invest in stocks after having lost billions of dollars in recent market crashes. All the three major online brokerages in US namely E*Trade, Charles Schwab, and Ameritrade have witnessed significant fall in the number of online trading customers and are struggling to cope up with the downturn in the market. Uncertainty has increasingly gripped the industry as smaller online brokerages are either closing their shops or are being gobbled up by big fishes desperately trying to consolidate their position to stay afloat. All the three big players have been on an acquisition binge in recent times. So, where is online trading headed for?

A volume game

The Internet boom led to a new phenomenon, the emergence of a new breed of stock investors, the day traders. As stock prices were pushed to astronomical levels by these so-called day traders, expecting Internet and technology start-ups to turn in unrealistic profits, more and more investors were lured by quick money. With significant growth in day trading customers, many old as well as new brokerage houses entered the fray. However, experts had cautioned that such a high level of growth in customers was never going to be sustained, as the online trading business became more of a volume play, owing to fierce cost-cutting among competitors.

The entry of discount brokerages like Charles Schwab started a price war among brokers, which ensured that margins were squeezed to the hilt, although clients were benefitted and drove the expansion of the market. Cut-throat competition had a telling impact on the bottom lines of brokerage houses. In fact, many experts even speculated that if the brokers were not making money at the time of boom, what would happen to them in bad times? And, they were right. As the bearish sentiment gripped the market in the aftermath of the dotcom burst, aided and abated by a slew of bad news in recent times such as September 11 attacks, accounting scandals and the ongoing war in Iraq, brokerage houses are scurrying for cover.

With no signs of market revival in sight, wary investors have been

> **Online trading is a viable model because it makes it easier and cheaper to invest.**
>
> **Richard Wayman**
> *President*
> *Researchstock.com*

reluctant to return to the market, putting further pressure on the online brokerage business. "With the country facing unprecedented geopolitical uncertainties, we saw further erosion in our clients' trading activity during February," said David Pottruck, President, Charles Schwab, in a statement recently. This vindicates the growth concern of industry players. According to an estimate, Schwab's clients made an average of 101,500 trades a day in February this year, excluding mutual fund transactions. This was a drop of 28% compared to the corresponding period in the last year and down about 16% from January this year. In fact, on an average, discount brokerage's clients made just 96,000 trades a day in the first seven trading days of March, as revealed by the company's president. The rival Ameritrade, which had to cut this year's March quarter profit forecast, announced that its trading volumes slipped 25% in February.

The negative market sentiment is reflected in the fact that daily share volume on the New York Stock Exchange has dropped by 8% compared to last year while it is down 27% on the Nasdaq. At the same time, the average number of online trades, which peaked in 1999 at 800,000 a day recorded a steep decline reaching 390,000 a day, during 2002. This meant lower commissions for brokers such as Charles Schwab, Merrill, Ameritrade, and E*Trade.

Apart from the persisting bearishness, fall in trading volumes, and shrinking commissions, the online brokerage business has been affected by another factor. That is, the retreat of the individual investor. All the three major online brokerage firms namely Charles Schwab, E*Trade, and Ameritrade have admitted to loss in trading volumes in recent times, with war threats further dampening the investor sentiment during the first three months of the current year. These firms have said that their February trading volumes tumbled from January's already low levels. As a result, their stocks sank further during March this year. Shares of Charles Schwab are now off 87% of their 1999 peak whereas Ameritrade is off 93% of its highs in 1999. The third firm of the discount brokerage troika has lost 94% after reaching an all time high of $62.75 during April 1999.

A Steep Fall

Company	Stock price (in $)	
	As on 13/4/1999	As on 17/4/2003
Charles Schwab	50.17	8.63
Ameritrade	57.75	5.00
E*Trade	62.75	4.54

To counter the slowdown in business, online brokerage houses are diversifying into other businesses such as mortgage banking, insurance, personal loans etc. To boost their bottom lines, many brokerages are resorting to severe cost-cutting measures as well. But, is the move to get into other businesses warranted? "They are adding to their services by appealing to investors who are 'discovering' that they need professional help and want to talk to a person, in person," opines Richard Wayman, President, Researchstock.com, USA. The three major online brokerage firms have embraced three different business models. Charles Schwab, which is by far the biggest online trading firm with more than $4 bn in revenue recorded last year, has diversified into money management business. E*Trade, with $2 bn in revenues in 2002, has a retail bank with lending and ATM services. However, of the three firms, Ameritrade has remained fully focused on its online brokerage business.

Perfect future?

Despite persisting weakness faced by online trading firms, staunch believers in online trading feel that the business will survive. "I think online trading is a viable model because it makes it easier and cheaper to invest. Just grin and bear it," advises Wayman.

Experts also put down any suggestions of Internet trading firms going the dotcom way as they suggest that online trading works and is about dealing with real things, unlike several dotcom firms which did not have a viable business model to work on. They say that the current battering taken by most of the online trading firms is because of the general sluggishness in the market and in fact, are trading at levels that assume an unreasonably downbeat outlook.

This may sound too optimistic. However, one thing is sure – online trading is here to stay. There is no denying the fact that Internet trading offered investors not only the convenience of trading from within the comforts of a home, office or, wherever they were, it has also helped bring down the cost of trading. The information glut brought about by the Internet's advent also helped bridge the gap between those who are informed and those who are less-informed investors. Now, anyone can have access to a host of information on a company or a stock and research reports. Reaching the companies too has become easy. All the more, online brokerage houses also keep updating clients at regular intervals. To add to it is another attraction and what Economist says, that the Web is a wonderful place to ask stupid questions, or to make blunders in apparent privacy. Perhaps, these reasons could be strong enough to entice investors to return to the market.

Amit Singh Sisodiya

Reference # 1-2003-05-02

IRAQ

Post-war scenario

The fact that about 20 countries, from France to China, have interests in Iraqi oil production exacerbates the situation further, says Michael J Economides, Professor, University of Houston and author of *The Color of Oil*.

The impact on the 'Arab street' will be devastating during post-war times and, perhaps it is the ultimate effect desired by the US war planners. The vestiges of power play a huge role in the culture of Arab countries and often reality is confused with desire. Many Arabs and, indeed Moslems, who would not have much love lost for Saddam admired his confidence against what had been presented as the modern manifestation of the Crusaders. The unceremonious collapse of the Saddam regime will have a wrenching psychological effect on many. Instability may become the norm and the United States, now trumpeting its adherence to democracy in the Iraqi 'regime change' will have difficulty defending its allies in Egypt, Jordan and the most vital of them all, Saudi Arabia. The managing of Iraq will prove to be not a bed of roses, after the initial made-for-TV euphoria of some of the occupied locals.

The 1969 Vienna Convention, which the United States prominently signed, describes rules a 'belligerent occupier' must follow in administering an occupied territory. This becomes important because of the accusation—often repeated by Iraq and many others, including close allies of the United States—that the purpose of the war was to take control of Iraqi oil. Such an act would in fact be a war crime, and avoiding it would be a formidable task, when one considers the Iraqi petroleum potential, oil's unique position in the Iraqi economy and the importance of reasonably priced oil for our own economy.

This is what the Vienna Convention requires from the belligerent occupier: "The occupant must continue an orderly government and may exercise control over and utilize the resources of the country for that purpose and to meet his own military needs. Services may be requisitioned, but workers cannot be forced to operate against their country, and are limited to cater to local needs. They cannot be used for the general benefit of the occupier's homeland." Part of Iraqi oil can be used to pay for the occupation's military cost, but the rest of it must be used strictly for the benefit of the Iraqi people and reconstruction.

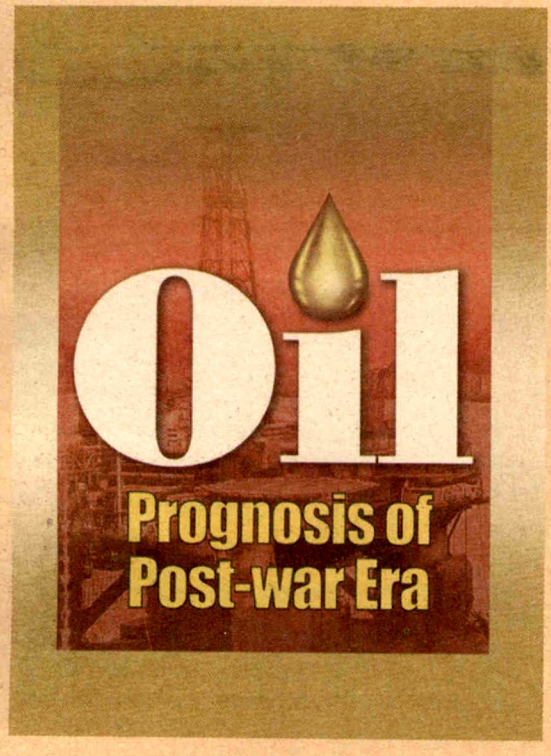
The meaning is simple; its accomplishment will be a nightmare. The United States military and the government back home, will have to quickly become one of the largest oil companies in the world. It is hard to manage an oil company in the most peaceful of times and with some of the most skillful managers. Doing this right in the post-war Iraqi environment will be a breathtaking achievement. The fact that about 20 countries, from Russia to France to China, have interests in Iraqi oil production exacerbates the situation further. This situation will create economic, legal and technical problems, which have hardly been debated as the war drums deafen us.

How will the United States run the Iraqi oil industry, which it must do, as it is the only income source for that population? Will the administrators increase production by using technology not currently available because of the sanctions? Will Iraq produce more oil to lower prices, benefitting the United States and the rest of the developed world, already in a prolonged economic downturn, or will it produce less, for example by obeying OPEC quotas, already being called by a number of OPEC oil ministers, benefitting the Iraqi treasury, whose well-being will become the United States' responsibility as the occupier?

There are even more vexing questions beyond the macroeconomic issues. Will the US-placed Iraqi oil managers choose drilling targets in difficult geologic structures currently impossible in a constrained Iraqi oil industry? Will they use complex wells, stimulation, drilling and measurement technologies? And would all this optimization and engineering, benefitting US service companies, which are almost exclusive vendors of petroleum technology worldwide, fly against the Vienna Convention, which seems to suggest maintaining production without further exploitation, which would seem and indeed be for the benefit of the occupier?

The 1991 Persian Gulf War had the fig leaf of respectability under the UN umbrella. Getting the Iraqi army out of Kuwait was easy, a discernible aim and painless. No war was declared and the niceties and ethics of modern warfare and behavior did not have to be tested. Invading Iraq, occupying it and managing it afterward is another matter.

Reference # 1-2003-05-03



OIL Prognosis of Post-war Era

For nearly three decades, oil prices have been controlled primarily by the oil cartel – OPEC, through the control it has on majority of oil producing countries. That may no longer be the case if America succeeds in its objective of having a major say in Iraq's affairs. Iraq's oil industry is capable of far higher production and could break the Saudi hold on OPEC. A fresh price war among producers is not ruled out because OPEC might be forced to change its policy of defending prices and its market share.

After Saudi Arabia in the Middle East, Iraq possesses the world's second-largest oil reserves, estimated at 112.5 billion barrels, or 11% of the world's total—more than five times the size of US reserves. However, despite sitting pretty on such huge reserves, the beleaguered country currently supplies only 3% of the world's oil. The country has massive untapped reserves; about 90% remains unexplored. Oil production costs are among the lowest in the world, making it an extraordinarily profitable source. It also controls nearly 3.1 trillion cubic meters of natural gas to rank among the top 10 gas powers, but most of this wealth has remained untapped. It is not a surprise that there is not an oil company in the world that doesn't eye Iraq. More than a decade of UN sanctions have taken their toll on Iraq's oil reservoirs.

Under the sanctions, Iraq was not assigned OPEC (Organization for Petroleum Exporting Countries) quota and the oil-for-food program regulated its exports. Under this scheme, Iraq was allowed to sell up to 2 million barrels per day, provided the revenues were used for humanitarian assistance to the Iraqi people and the repayment of Iraq's war debts to Kuwait.

In the last 20 years, Iraq was unable to expand its exploration program because of the 1980-88 Iran-Iraq war followed by UN sanctions, in place since 1990. Despite UN's additional funds for oil spare parts, Iraq does not have modern recovery techniques that would allow it to raise production without damaging its reservoirs.

On the other hand, the oil industry by an extension—the American industry; surprisingly out of the five companies that dominate the world oil market, four are based in the US and Britain. Exxon-Mobil, Royal Dutch-Shell, British Petroleum, Chevron-Texaco and the fifth, TotalFinaElf, a French-Italian company.

The US outfaces any country in consumption and imports over half of what it consumes, its market makes up a quarter of the world's demand for oil. With just 3% of the world's population, it consumes more than 25% of crude oil; about 20 million barrels a day, up from 15 million two decades ago, roughly equal to its share of the global economy. The US economy runs on oil and in fact no other commodity exerts as much leverage over its financial health.

Going by these facts, it shows the crucial role played by oil prices in the US economy. If oil prices touch $40 a barrel and stay there for a couple of months, the US economy will be back to recession. Economists calculate that every $10-a-barrel oil price increase that sticks for a year reduces economic growth by 0.5%. There is the impact of oil prices outside the US. Countries such as Japan, Germany and France import all of their oil, so they are highly vulnerable to price increases.

If oil prices touch $40 a barrel and stay there for a couple of months, the US economy will be back to recession

However, the International Monetary Fund estimates that a $10 a barrel rise in the price of oil sustained over a year—roughly what happened last year—reduces global GDP by 0.6%. The impact varies from 0.8% of GDP in the US, the euro area and the developing countries of Asia—more in major importers like Korea, India and Thailand.

Politics behind oil

For nearly half a century, the US has been steadily increasing investments in the Gulf region. The investments have included direct and indirect forms of intervention, massive arms transfers to allies and the acquisition of military bases. In the wake of Iraq's invasion of Kuwait, Iraqi and Kuwait oil supplies were lost and oil prices spiked. Saudi Arabia pleased world oil markets by stepping up its production close to 60% in 1989-91. Following the Gulf war in 1991, the US supplied Saudi Arabia and allied Gulf States with massive amount of highly sophisticated armaments.

Though reasons behind America's present war against Iraq, as the economic superpower articulates, are eliminating Iraqi weapons of mass destruction, the continuation of the war on terror, and the promotion of democracy in the region. Critics of war suggest, as they have always said, that the primary objective of the US was not the removal of Saddam or his alleged weapons of mass destruction, but Iraq's primary economic asset: Crude oil reserves.

Indeed, the US relies on the imports to meet almost 60% of its oil needs, a figure that is expected to go up in the next few years, and Iraq's figure being second only to Saudi Arabia in untapped oil reserves, it is tempting to dismiss the war as a war for oil.

They further add that the real reason is an oil currency war, to prevent further OPEC momentum towards the euro as an oil transaction currency standard. To regain control over the Iraq oil market, which the US and Britain lost when the Iraqi Government

The effects of regime change on world oil markets will depend very heavily on whether Iraq remains in OPEC.

Justin Wolfers and Eric Zitzewitz
Assistant Professors of Economics
Stanford Business School
US

nationalized its oil industry in 1972, is the key to maintain their dominance over this critical economic resource. Thus, the US is seeking to promote alternatives to Saudi Arabia and thus gain over OPEC price setting mechanism. However, Glen Burns, Editor, *INS News*, Sydney, contradicts this view. He says, "the US oil industry will find it difficult to reduce the dominant position that Saudi Arabia holds in the foreseeable future. They have the bulk of the world's reserves and after the war, even if the United States gains additional oil reserves, it appears it won't be enough to challenge Saudi Arabia.

Whatsoever the reasons behind the war, Yale University's Prof. William Nordhaus factors in the impact on oil and the world economy to reach a high-end estimate of $1.92 tn. He further adds, followed by the quick victory in Iraq, the stability in the region could lead to increases in oil production capacity in Iraq, Iran and other countries will put downward pressure on oil prices.

An El Dorado for the US?

Once UN economic sanctions on Iraq are lifted, the question which

would emerge is, who will control Iraq's vast oil reserves? In a post-war Iraq if a pro-US government takes over the reins of the country, whose chances are strong, it could be a bonanza for US oil companies. Iraq's vast oil reserves remain a powerful prize for oil companies. However, development of those Iraq reserves will not be a small project. After years of havoc, Iraq's oil infrastructure will require tremendous hard work and billions of dollars in investment. The oil industry is in terrible shape, the pipelines are leaking lakes of oil, refineries are dumping toxic waste, in short, it is a broken down industry.

Oil production, currently 2 million barrels a day, even in the best-case scenario, this cannot reach more than 2.5 million barrels a day by 2005. Current Iraqi production capacity is not an immediate threat. It will be years before they can pump significant amounts of oil. However, Dr. L Y Yueh, Economics Department, London School of Economics opines that the operations of the Kirkuk oil fields are expected to revive within weeks and can produce 9 million barrels per day—nearly half of Iraq's pre-war production levels.

Oil experts say, in the long-term the country has great-untapped oil reserves and its output could eventually reach 6 million barrels a day. The American Academy of Arts and Sciences estimates that over 10 years, war and the reconstruction of Iraq could cost as much as $2 tn—almost the equivalent of the entire annual federal budget.

US oil companies will not gain any particular benefit. Should prices rise, then all oil companies' benefit, and the US companies will be no exception

The US oil companies have been stuck on the sidelines because of Iraq's oil rush. Even if iraq wanted to engage US oil companies in the rebuilding of Iraq's oil infrastructure, UN sanctions as well as US laws have barred US oil companies from dealing with Baghdad. According to a report by the Council on Foreign Relations (CFR) and the James Baker Institute of Rice University, Iraq's oil is not the prize it seems from afar.

In short, the Iraq war would further disrupt Iraq production, resulting greater power for OPEC. Another report from Center for Strategic and International Studies (CSIS) observes that, after a regime change, there would be many competing claims for money that would slow investment in oil, buying food, financing reconstruction, and keeping the pace. Iraq also has debts of over $100 bn. Some oil experts say it is unlikely that US companies will be left empty-handed, going by US oil industry's unusually strong ties with the White House.

Critics say the oil companies are driving Bush's war. The *Wall Street Journal* reported on January 16, this year, that officials from the White House, State Department and Department of Defense have been meeting informally with executives from Halliburton, Slumberger, Exxon-Mobil, ChevronTexaco and ConocoPhillips to plan the post-war oil bonanza.

However, a lot depends on just what kind of government will be in power when UN sanctions are lifted and also largely on the extent to which post-war Iraq respects the pre-war exploration contracts; most of which are with European rather than US oil companies.

Prof. Stephen G Cecchetti, Department of Economics, The Ohio State University, US, says, "If Iraqi oil resources are to be used to benefit the Iraqi people, as the Bush administration says they should be, the outcome for American oil companies will be neutral. My hope is that the organization of production and ownership will mirror that of the state-owned, but privately run, Mexican oil company Pemex. If, as I believe, oil prices remain in the $20 to $25 range for the next few years, American oil companies will not gain any particular benefit. Should prices rise, then all oil companies will benefit, and US companies will be no exception. But we can all hope that this does not happen, as it would have dire consequences for everyone else."

> **"I expect in the coming years oil price will stay relatively stable in the lower end of the OPEC price-band ($22-28 per barrel) as it has been shown that the actions in this war have no real impact on the supply-side."**
>
> **Alexander Wostmann**
> *Director, Content*
> *Alexander's Gas & Oil Connections*
> *Germany"*

However, any production decisions of Iraqi oil are still under the jurisdiction of the UN Security Council, based on the sanctions against the Saddam regime, which the US so forcefully brokered over the years. Ironically, these same sanctions must now be lifted and their removal is subject to the votes and vetos of countries such as France, Russia and China, which not only opposed the war but also have very large interests of their own in the Iraqi petroleum industry, already in place.

OPEC – Fading power?

With the end of the Saddam regime, US has achieved its twin goals: Removing Saddam from power and reducing oil cartel power in manipulation of prices, engineering embargoes and otherwise harmed consumers. A revitalized Iraqi oil industry will pose new problems for the mighty OPEC, whose 10 members curved up Iraq's production quotas when UN sanction took hold. OPEC's manipulation once held the world to ransom, prompting the 1973 oil shock, which sent the world economy into turmoil. Now the trend has changed, the future direction of oil prices lies out of its hands. The cartel's leaders have been openly telling the world that their days of power are numbered.

During 1970s, OPEC controlled half the world's oil market, this may have been even true years ago, but OPEC's share has been in steady decline. The cartel is on the verge of losing its ability to set world prices, a power known in economics as price leadership. If that market share drops below 30%, OPEC's dominance could officially become a mere relic of history.

By some estimates, a rebuilt Iraqi oil industry can produce as much as 6 million barrels a day, second only to Saudi Arabia as top OPEC producer, would be devastating for the Saudi-controlled oil cartel. A fresh war among producers is not ruled out because of the fact that OPEC might be forced to change its policy of defending prices in order to defend its market share.

Analysts say as Iraqi production rises, oil prices are likely to fall unless OPEC cuts back elsewhere. The Iraqi people would be better-off from higher revenues and people around the world would benefit from a significant drop in oil prices. But it is not clear how closely Iraq will cooperate with OPEC once sanctions are lifted. Justin Wolfers and Eric Zitzewitz, Assistant Professors of Economics, Stanford Business School, US, observe, "The effects of regime change on world oil markets will depend very heavily on whether Iraq remains in OPEC. Of course, if Iraq remains in OPEC, then this will suggest a return to something closer to 'business as usual' in the long-run, although Iraq may ultimately negotiate a somewhat larger quota. Even if Iraq does leave OPEC, there is a chance that increasing Iraq supply would still be somewhat offset by lower OPEC production." But in the short run, very little oil will come from Iraq without significant investment.

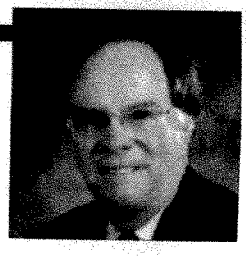
Stability of the oil market will continue to depend on the ability of OPEC to control production—the end to political strife in Venezuela, and the stability of the Persian Gulf region.

However, Glen Burns says that Iraq will be in the same position as Saudi Arabia, it will want to keep the oil prices higher, to protect its long-term future. OPEC will continue to play a part; and that Iraq can join OPEC. The outcome of a post-Saddam regime, if it happens, is unclear. If Iraq doesn't join OPEC, outstanding oil contracts are likely to be honored and any new capacity won't reach the market for many months, after the war to allow time to rebuild Iraq's oil capacity.

Estimated Impact of Oil Price Increase of $10 a Barrel

	Real GDP change
World	-0.6
Industrial Economies	-0.6
US	-0.8
Euro Area	-0.8
Japan	-0.4
Others	-0.2
Developing Countries	-0.4
Latin America	-0.2
Asia	-0.8
Europe and Africa	+0.2

Source: www.globaldimensions.com



"As for the notion that once the war is over, prices will fall, this can happen if speculators keep increasing their very high short positions on the crude contract."

Matthew R Simmons
Chief Executive Officer
Simmons & Company International
(Investment Bankers to the Energy Industry)

Oil prices: Post-war scenario

As pre-war surge ended, the oil prices plunged currently to four-month lows or less than $25 a barrel after almost reaching $38 a barrel in the trading week of February 24-28, 2003. Unlike in the past, the war on Iraq has had far less impact on oil prices; timing and the fact is that Saddam has not managed to wreak havoc in the oilfields as he did in 1991.

As the war ends like a cakewalk, once the Iraqi oil starts flowing into the world markets, nudging prices will be back to low double-digit level. Justin Wolfers and Eric Zitzewitz predict that "oil prices are almost certainly going to fall back to pre-war levels, once it becomes clear that not only the military, but also political disruption dissipates." They further add, "Our calculation is that oil prices are probably about $11 per barrel above levels they would otherwise

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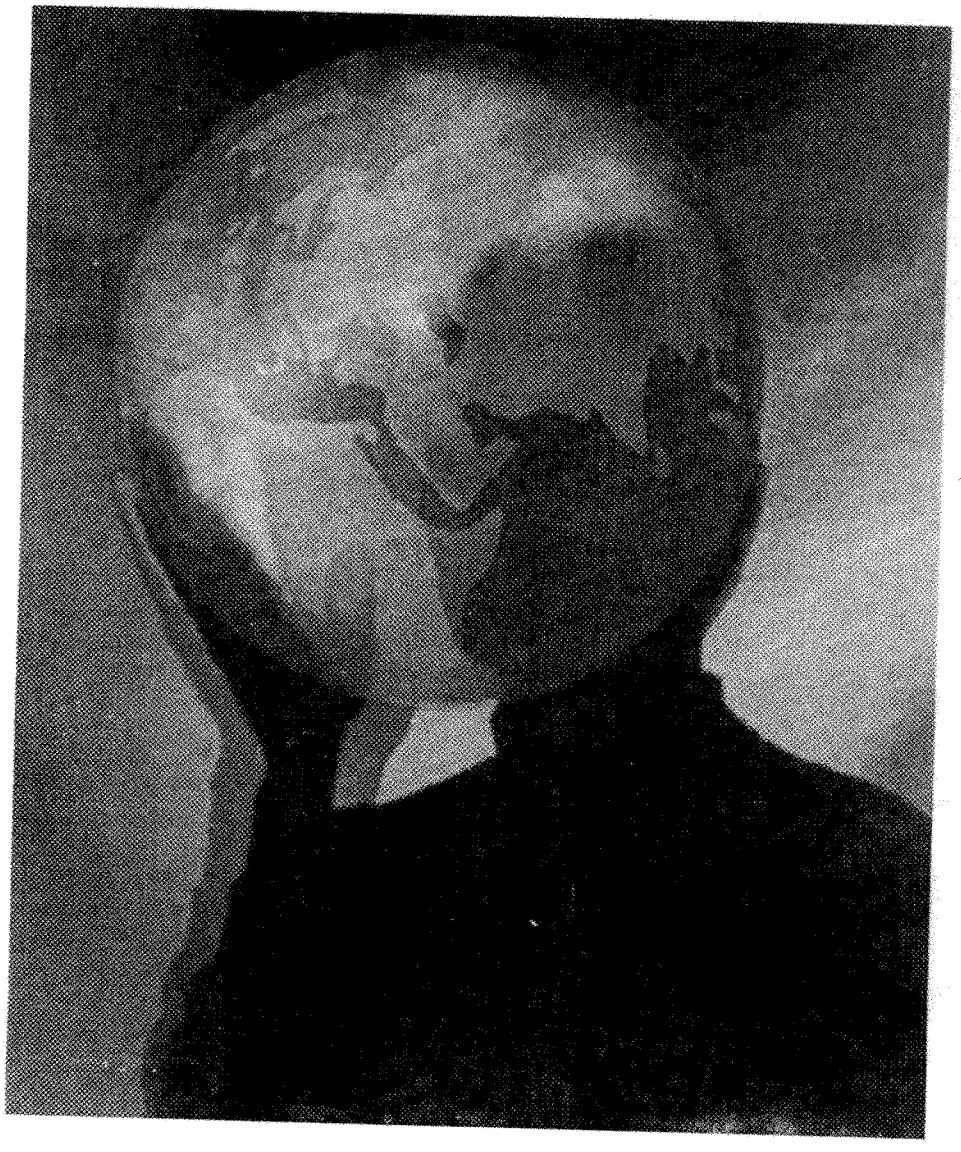

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be at, with the delicate situation in Venezuela is also a factor. Moreover, our guess is that this process of re-equilibration will be relatively quick, with the war premium disappearing within about a year of the end of hostilities."

If one goes back to history, oil prices soared when Iraq seized Kuwait's oil fields in August 1990. The benchmark US crude oil rose from just over $21 a barrel in August to more than $40 in October, as the administration began preparations to retake Kuwait. But from that peak, oil prices began falling, and the launch of the allied offensive in February 1991 cut $10 a barrel off the US crude prices. By the end of that month, oil prices were below $20 again.

It is true that oil prices plunged quickly after the Gulf war. World oil markets and the supply equation are very different today; oil experts say that in this crisis, President Bush faces challenges in global energy markets that his father did not. In the earlier Gulf crisis, gasoline prices did not increase as much as crude oil prices because gasoline inventories were adequate.

In the earlier Gulf crisis, gasoline prices did not increase as much as crude oil prices because gasoline inventories were adequate

This time, however, consumers are not as fortunate. Gasoline prices have closely tracked the climb in costs of crude oil from which the gasoline is made. The average pump price of $1.71 per gallon on March 10, 2003 was the highest ever for this time of year, 49 cents above the level of a year ago, says the Energy Information Administration, US.

However, Justin Wolfers and Eric Zitzewitz opine that "there will be a dramatic price collapse—but initially only to pre-war levels. And whether a long slow decline drawn out over a year or so is dramatic, or orderly, is of course a question of personal taste. In the much longer run there is still some discussion about whether this war will increase Iraq's supply enough to have an impact on world prices. Our assessment is that there will be some impact, but that it will be relatively small, and the long-run (10-year) effect may be to reduce oil prices a further $1-2 per barrel, which strikes us as small." The longer-term view is that oil companies have little to worry about; demand is steadily increasing, while supply is constant, meaning that the prices will rise. Any sudden changes in oil supplies if they happen will be short-term and appears unlikely. Nevertheless, Stephen predicts that oil prices are likely to fall back to somewhere between $20 and $25 a barrel from the current level of $28.

They further add, there is no flood of Iraqi oil and there is likely to be none for the coming years. The price is under pressure because everyone has been hoarding oil over the last months and as the war seems to be almost over without too great an impact, there is just an enormous amount of oil in storage, floating or fixed.

The oil economics

High oil and gasoline prices are of great concern to world economy. Since they weaken consumers' ability to spend on other things and raise costs for businesses. All the big oil spikes in the past 25 years or so have resulted in recessions, and some economists have worried that the recent spike could result in another one.

The recent drop in prices, then, should be something of a relief. But the spike already may have contributed to a dramatic slowdown in growth earlier this year, helping to drive consumer confidence to lows not seen in about a decade. High prices will continue to depress the world economy, and is severe enough to place the economy in recession, until the economy is able to react to this reality. Stephen echoes similar views, "If oil prices were to double or triple, the problems would be severe. While oil is less important today than it was 30 years ago, a significant increase in energy prices does have an immediate and large impact on the world economy. The weak growth would turn into an almost immediate recession."

History tells that sustained oil-price rises have a big negative impact on economic growth; similar effects were seen after the next big price hike in 1978-79. The continuation of oil prices in 1990s affected to end the long boom which, in the US and parts of Europe and Asia, turned into recession. Since then recovery has been so tentative. This explains why the recent surge in prices has alarmed the world economy. Economists opine that the overall impact on world demand depends on whether oil exporters save their windfall or spend it on imports from oil-consuming countries.

"There is unlikely to be an oil price shock at this time. Oil prices are not rising but falling, further reducing the scenario of a supply shock."

Dr. L Y Yueh
Economics Department
London School of Economics

However, on the other side, drop in oil price could also have a domino effect on other sectors of the oil economies, leading to economic slowdown and a growing unemployment problem.

Relative to the major recession-causing oil price hikes in the 1970s, this one is likely to be both smaller in absolute magnitude, but more important and far less persistent. As such, it is unlikely to cause the same sort of economic dislocation that past oil price shocks have caused.

Justin Wolfers and Eric Zitzewitz opine, "we still see first-order macroeconomic impacts flowing from this war—we just aren't sure that oil prices will be the mediating mechanism. Our best estimate is that the stock market has priced in a 15% penalty due to the war (now perhaps closer to 10%). This strips away about $1 tn from US stock market wealth, and similar effects are seen in other major economies around the world. While oil and gold stocks have done well, this is more than offset by large declines in consumer discretionary spending, and IT, not to mention more generalized losses. These losses are likely to have immediate impacts through consumption and investment on the future course of GDP."

In the post-Iraq war regime, the global oil industry is on the verge of a major structural change in the way the price of oil is determined

They further add, "Our guess is that this reflects a combination of direct economic effects (consumer sentiment etc.), and political economy effects. The war may have substantially compromised the ability of Bush administration to work effectively in international foray, including not only the UN, but also the WTO, or even in simply bilateral contexts."

On the US front, in the post-war regime, the importance of reconstruction of Iraq should be noted, of which the situation of its oil industry is a major part but only one part. A plan for reconstruction offers both opportunities and challenges familiar to those who have worked in transition economies, especially to those who have worked on issues of international law.

Beyond this, the key challenges are the damage done to international institutions and relations with its Western allies while at the same time tamping down the fierce anti-Americanism that has sprung up around the globe. Succeeding at those tasks would go a long way toward lessening tensions in the Middle East and elsewhere around the globe and muting criticism of the US for the unilateral approach it took to the war. But failure to do so would likely increase global tensions and further fuel anti-Americanism—an outcome that poses huge risks for business.

Outlook

In the post-Iraq war regime, the global oil industry is on the verge of a major structural change in the way the price of oil is determined. In the coming months, only two producers will set the world price of oil—Saudi Arabia and Iraq. This shift in pricing power will occur because non-OPEC production is projected to be flat or down in the years ahead, while Saudi Arabia and Iraq will be the only producers that have the resource base to permit an economic expansion of productive capacity. For 30 years now, the price of oil has been controlled primarily by Saudi Arabia.

OPEC members are required to produce only an agreed quota of oil to keep the price high enough to make a good profit but not high enough to force the West to seek other suppliers.

The Top Ten Oil Economies		
	Reserves (billion barrels)	Production (million barrels per day)
Saudi Arabia	261.8	8.8
Iraq	112.5	2.4
UAE	97.8	2.4
Kuwait	96.5	2.1
Iran	89.7	3.7
Venezuela	77.7	3.4
Russia	48.6	7.1
US	30.4	7.7
Libya	29.5	1.4
Mexico	26.9	3.6

Source: BP Statistical Review of World Energy

However, Iraq's oil industry is capable of far higher production and could break the Saudi hold on OPEC. If Iraq were under western occupation, this could allow the big consuming countries like the US, Japan and Western Europe—to call the shots. Furthermore, there are powerful interests both within the US and outside who don't want to see oil prices collapse.

American oil giants are exploring new fields in remote regions of Alaska, Colombia and Central and South-East Asia that will only be profitable to exploit at prices above about $22 per barrel. Then there is Russia, a non-OPEC oil power in its own right. The Soviet oil industry collapsed just before the USSR did, but Russia's is now back and already sparring with the Saudis because they have no use for OPEC quotas. So the oil is an issue—in a complex, long-term and very real way. If any one denies this, it is to deny the reality.

N Janardhan Rao

Reference # 1-2003-05-04

Oil Prices: Impact on Global Economies

The oil industry faces critical decisions about the future of the world's second-largest oil reserves. Should the US support to maximize Iraqi oil production? Or, should America protect the status quo of artificially high oil prices? The choice America makes will have profound repercussions on the future of the oil industry. UN sanctions against Iraq have been the decisive factors in holding down worldwide oil production and keeping oil prices high. Because of the sanctions, Iraq produces fewer than 2.5 million barrels of oil a day—far below what the country's huge oil resource base can sustain. Under post-Saddam regime, America's challenge is to formulate an energy policy that promotes long-term political stability and economic growth while minimizing the negative effects of lower oil prices.

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Industry's fear of price collapse

C J Campbell (CJC): World oil supply will reach the peak by around 2010 following the peak in discovery during mid-1960s, as of now confirmed by Exxon-Mobil. We now find about one barrel for every four consumed. The companies are far from replacing reserves by new discovery. They have accordingly no reason to fear prolonged low prices, and shrewd traders can make good money from the likely wild fluctuations by a market that is largely ignorant of the underlying resource constraints.

Vandana Hari (VH): I totally disagree. The picture is completely the opposite. A weak global economy further hit by the tourism and aviation industry in the doldrums and the SARS outbreak in South China, Hong Kong and parts of South-East Asia might drag oil demand even lower.

Horatio Mortimer (HM): I think the oil industry is right in thinking that production levels are too high. The price may be temporarily lifted if OPEC decides to cut production while they still can before Iraq comes fully back on stream.

Saby Gangluly (SG): Abnormal increases in oil prices in the past were due to political tensions in the Middle East. Even today, it costs less than $3 to produce a barrel of oil in the Middle East. But due to cartelization by some 15-odd oil-exporting countries, they are priced as high as they are. Even if oil prices were to fall to $15 per barrel—which we would consider low—it would give an 80% profit margin to exporters like Saudi Arabia and Kuwait. An 80% profit margin is unfair, and even at this margin, the price ($15) would be considered 'very low'. To come back to the question, world oil markets have learnt to live with political flare-ups in the Middle East. As a result, in the more recent crises such as Gulf Wars I and II, we didn't notice the kind of inflationary panic we saw in 1973-74 and 1979. As for the post-Gulf War II scenario, there already are signs that we shall not see any budget-upsetting kind of oil price increases. If Iraq resumes exporting 2 million barrels per day, prices will fall due to oversupply. Whether the Government of India passes on the savings to the consumers is a different matter.

Challenge to Saudi Arabia's position as market leader

CJC: The US oil industry may secure a strong position in post-war Iraq, which will help it offset the 30-year decline in domestic production. It may also take a strong position in deep-water operations in the Gulf of Mexico and West Africa, which are also likely to peak around 2010. It is possible, however, that the Saudi regime may fall from popular discontent, which may give the United States the pretext to take the Saudi fields, in which case the US industry would come to control Saudi Arabia too. In that event Saudi Arabia will no longer be a challenge.

VH: It remains to be seen what role US oil companies will play in the post-war Iraq. That US firms are going to play a major role in the

reconstruction efforts, including the Iraqi oil sector, is already clear. If the US majors are able to wrest for themselves the major producing fields, and new production sharing agreements and exploration blocks, US dependence on Saudi Arabian oil would certainly ease.

HM: The US oil companies are not in a position to challenge Saudi Arabia. Only thing that might affect Saudi primacy would be internal politics, and no regime would be able to last very long without the oil revenues.

SG: Even though the US is also a primary producer of oil, its demand exceeds its domestic production. So, what we mean by the term 'US oil industry', we mean it's oil refining industry. On the other hand, Saudi Arabia is a primary producer of oil: Its refining industry is not a big force. I don't see how a refining industry can challenge the position of a primary production industry. The two are not competitive: They are complementary.

OPEC's role

CJC: There is most unlikely to be a flood of Iraqi oil. Its reserves have been generally exaggerated as in most OPEC countries, and the scope for new discovery is much less than widely assumed. The amount of work to rehabilitate the aging fields, bring on the smaller fields awaiting development, never mind finding new fields, should not be underestimated, especially if the country remains subject to sabotage and political instability as is likely.

VH: This would really depend on Iraq's continued presence in OPEC. If Iraq remains a member of the cartel—which I personally think it will—it would be bound by OPEC quotas. Under the UN sanctions regime, Iraq was not assigned any OPEC quota and its exports were regulated by the oil-for-food program. If the country returns to its pre-sanctions OPEC quota, it would be pumping close to $4-mn b/d (barrel per day). Any further increase would require substantial investment in the Iraqi oil infrastructure, which could take a few years, plus negotiations with OPEC to raise the country's quota, which would not be easy. Revisiting OPEC member quotas is an extremely sticky issue for the cartel, and is akin to opening a Pandora's box.

HM: It will take some time before Iraq reaches full capacity. However, there is already overproduction, and weak demand. As market fears subside I expect the price to fall. OPEC may try to lift prices by cutting production, but in the long-term, this will damage OPEC as it loses market share. Received wisdom suggests that in the long-term demand for oil will rise due to development in China and other emerging markets. My concern is that this pattern of growth is not as robust as some people think.

SG: Iraq used to export some two million barrels per day before the UN embargo was imposed on it in 1990. If this supply is restored, yes, Saudi Arabia will fail to keep prices above US$20 per barrel, except in the unlikely event of it assuming the role of OPEC's 'swing' producer once again. However, for reasons I have already stated, Saudi Arabia is unlikely to resume that role again.

Implication of higher oil prices

CJC: Expensive oil followed by physical shortage beyond 2010 would have a devastating impact on the world economy and the US economy in particular as it is so heavily in debt. Oil is the world's premier fuel, which made possible the economic prosperity of the past century. The population expanded sixfold in parallel. Never before in human history have we faced the global decline of a premier energy source, which is set to commence around 2010 due to ineluctable resource constraints. It implies a major change in economic principles. The scale of the change is hard to grasp, yet it is imposed by nature. Non-conventional oil and other renewable energies will be stepped up but will not have much impact on overall peak or be available in anywhere near the abundance of past oil.

VH: I see little chance of that happening now. OPEC would likely restrain production to support prices, probably aiming at maintaining them in the $22-28/bbl range for its basket price. Mid-term to long-term, since the possibility of an 'oil shock' as a result of a US-led attack on Iraq has vanished, oil prices should return to 'normal' levels, reflecting the market supply and demand fundamentals. That bodes well for an economic recovery.

HM: The oil price affects every corner of economic activity throughout the world. There are no limits to the damage that can be done. I think that there will be a dip in the oil price; the crucial question is whether the dip will last long enough to boost the global economy. If prices remain low for a sustained period, then it will have two effects. It will destabilize Saudi Arabia, and it will boost the global economy and therefore demand. If the Saudi regime survives, then it should be able to increase production and revenues as demand increases, and hold OPEC together. If the regime collapses, then there would be rising demand, and probably a temporary fall in production, as well as unprecedented uncertainty. The result would be oil prices rising to $100/barrel, and a global depression.

SG: Expensive oil is bad for the world economy. Cheap oil is good. This is too simple to need any elucidation.

Privatization of Iraq's oil

CJC: The companies will be very cautious about investments for a long time to come in Iraq. They will not want to work in a battlefield. It will be a long time till the whole concessional system is worked out. China and Russia will not want to be left out.

HM: It depends on whether the US to bow to pressure and allow a United Nations administration to

allocate the contracts, but I imagine even an American interim regime would allow in a few token non-Americans. In any event, I would be surprised if many of the existing contracts, such as those with Lukoil were to be honored.

SG: I am not sure if primary oil resources would be allowed to be privatized like an airline, especially in the Middle East, where oil resources are all that those countries have. Leasing out oil concessions to privately owned US companies is already a long-established practice in the Middle East. I think US oil companies would be happier refining cheap Iraqi oil rather than owning primary oil resources.

Future direction of oil prices

CJC: I think oil prices will fluctuate in an emotional and irrational market. There is very little realistic spare capacity anywhere, and it will be many years before Iraqi production can expand significantly. There is likely to be continued violence in the Middle East and elsewhere which may interrupt oil supply. If the economy improves, oil demand will rise until it again reaches the falling ceiling of capacity, last breached in 2000. Consequential recurring price shocks will likely re-impose recessions in a vicious circle. Prices in any event are likely to rise greatly by 2010 as the Middle East will by then no longer be able in practice to offset the natural decline elsewhere.

VH: Prices have already been falling and are bound to fall further in the coming weeks, unless OPEC takes some concrete measures to rein in its production. Platts estimates the 10 members of the 11-member cartel that are bound by quotas (excluding Iraq) are currently pumping about 26.3-mn b/d, a significant 1.8-mn b/d above their collective agreed ceiling of 24.5-mn b/d. The market is further weighed down by the bearish factors of an expected dip in seasonal demand typical of the second quarter, and high stocks accumulated by various governments and companies in consumer countries as part of their contingency measures ahead of the expected war on Iraq. OPEC had boosted its production to make up for the shortfall in Venezuelan crude output as a result of a national strike in that country through December, then the Nigerian crude outage in March, and the loss of Iraqi oil from the market. However, all these factors are set to disappear fast, and in fact there are fears that an Iraq released from UN sanctions might return to the market at close to 4-mn b/d, twice the volume it was supplying under the UN oil-for-food program.

HM: I think prices will fall immediately after the war, if not before, as there is already overproduction, and it is only uncertainty that is keeping prices at their current levels. However, new uncertainties resulting from the indirect consequences of the war may push prices back up again in the medium-term. A chaotic and ungovernable Iraq, in which US forces are forced to impose tough military discipline, could seriously destabilize the government in Saudi Arabia, which would already be under considerable stress due to falling revenues arising from the low oil price.

SG: Oil prices, as we know them today are not due to the result of a market mechanism. If it were left to market forces alone, oil would be selling for $3 or $4 per barrel even today. Oil prices as they are today, are the result of cartelization by the members of OPEC. It has been seen in the past that when there has been a glut in the oil market, the member-nations of OPEC launched production wars, i.e., they produce more than they are supposed to under OPEC quotas. This kind of production wars worsen the glut and reduce price even further. In the past, we have seen Saudi Arabia acting as the 'swing producer', i.e., reducing its own production to soak the glut, or increasing it to control excessive escalations in price. In the second-half of the 1990s, however, Saudi Arabia abandoned its role as OPEC's 'swing producer' and, instead, countenance low oil prices. In the current scenario, when Saudi Arabia's ruling elite cannot but be nervous by what has happened to Saddam Hussein, I don't think they will do anything to firm up oil prices. It is in America's interest, in India's interest, and in the interest of all oil-importing countries, that oil prices remain as low as possible. I don't expect Saudi Arabia to resort to any mechanism to hold up prices. So, oil prices seem likely to stay low, though oil should not be priced more than $3 per barrel in a free and fair market. But the oil market is not free and fair, so even $20 seems a reasonable price.

Outlook

CJC: It is said that the main reason for the US invasion of Iraq was the fear that other countries in the region would follow Iraq's example of requiring to be paid in euros and not in dollars. It seems that the expansion of US domestic debt has exactly matched the cost of oil imports. It is significant that France and Germany the cornerstones of the euro, supported by Russia, were strongly opposed to war, while Britain with its pound sterling being more linked to the dollar joined the United States. It may herald the onset of a new cold war between the euro and the dollar. Oil transactions are a critical part of the conflict, especially since in large measures they represent revenue rather than the cost of goods and services.

SG: If the fall of Saddam Hussein results in very low oil prices over the long-term, and if cheap oil does not make us complacent about energy conservation, the fallen Iraqi dictator might be seen in history as having done at least one good thing for mankind.

(Coordinated by N Janardhan Rao)

Reference # 1-2003-05-05

STATE BANK OF INDIA

Aggressive game plans

Feeling the pinch of competition, the largest public sector bank in India is aggressively trying to come up with innovative schemes in order to hold on to its market share.

State Bank of India (SBI), the biggest and the largest public sector bank of India, since its establishment in 1951 has done a lot towards the development of the country. SBI has established a wide reach all over India with its 9,034 branches and a market share of over 20%. The bank is consistently trying to increase its hold in the retail and wholesale market by entering into businesses like credit cards, insurance, brokerage, gold, etc. Recently, it has started cross-selling insurance products, and also focusing on the most profitable home loan business.

In order to move with the time, SBI has fully computerized 3,345 branches, and has also deployed 1,163 ATMs. Despite its wide network, SBI could not capitalize on it in capturing the retail market of the post-liberalization era. Having realized the need of the hour, the bank is now trying to increase its presence in the retail business by employing new and innovative schemes.

Performance analysis

SBI is one of the most profitable banks in India. It is on the way of creating a niche for itself in the banking sector, and this may be justified by analysis of its financial statement. The net profit of the bank has increased to Rs. 2,367.45 cr for the 9-month period ended December 31, 2002 from Rs. 1,815.93 cr for the 9-month period ended December 31, 2001, registering a growth of 30.37%.The operating profit of the bank has also given a good picture with a growth of 23.74%. It has moved up to Rs. 5,267.4 cr for the 9-month period ended December 31, 2002, from Rs. 4,256.69 cr in the same period previous year. Possibly, this growth could be due to a good performance in the Net Interest Income (NII) which have increased by 6.82% to Rs. 7,210.2 cr and also due to control on operating expenses and staff cost which have moderately increased by 4.66% (to Rs. 5,476.66 cr from Rs. 5,232.96 cr) and 3.99% (to Rs. 3,958.92 cr from Rs. 3,806.89 cr) respectively.

Advances have also given an impressive picture. Average level of advances in India during the 9-month period ended December 31, 2002 is Rs. 1,18,984 cr as compared to Rs. 1,05,905 cr in the 9-month period ended December 31, 2001, i.e., higher by 12.35%. The interest income on advances has also shown an increase. Average yield on advances declined to 9.17% from 9.96%, due to declining interest rates.

Average resources deployed in treasury operations in India went up by 14.47% as compared to the 9-month period ended December 31, 2001. Interest income on treasury operations increased by 6.85%, compared to the 9-month period ended December 31, 2001.

Average deposits in India (excluding Resurgent India Bonds/ India Millennium Deposit) rose by Rs. 26,622 cr, i.e., by 13.08% as compared to the 9-month period ended December 31, 2001. The cost of deposits witnessed a reduction from 7.16% in the 9-month period ended December 31, 2001 to 6.56% in the 9-month period ended December 31, 2002.

Eyeing the retail segment

SBI is trying to make sure that it does not lose the battle with the private players in the retail business. The bank is coming up with innovative products not only to tighten its present hold, but also to regain the lost grounds.

Housing loan portfolio of SBI stands at Rs. 11,000 cr, as on end January 2003. SBI has decided to reduce the home loan rate to 9% for loans up to 10 years and to 9.5% for loans above 10 years. Till now, the rate charged was minimum 11.25%. The new rate is applicable from April 1, 2003. The bank is reported to lose Rs. 200 cr due to cut in interest rate. Due to the higher rate, the customers were supposedly unhappy and shifting their accounts. This cut in rate could help the bank in winning back its previously unsatisfied customers apart from facing the competition from its immediate competitors like HDFC and ICICI banks.

SBI is also planning to introduce special Prime Lending Rate (PLR) for housing loans. Accordingly, housing loans of SBI would be attached to the SBI home loan PLR and not to the PLR of the banks. The bank is also planning to provide home loans at the rate of 9% to the government employees in Kerala, which probably has the lowest level of Non-Performing Assets (NPA) in the country. The NPA level in Kerala is less than 9% as compared to a national average of 15%.

The retail loan of SBI has grown by Rs. 992 cr in just one month from December 2002 to January 2003. Total growth in retail in 10 months till January 2003 is Rs. 5,459 cr of which home loan constitutes Rs. 3,301 cr and the bank's incremental credit is Rs. 7,884 cr, as on end January 2003.

SBI has recently introduced schemes like Doctor plus, Teacher plus and Justice plus. Through these schemes Doctor, Teacher and Justice, respectively would be provided loans at a cheaper rate, compared to what is charged normally. On home loans, teachers, policemen and judges will be charged 0.25% lower than interest charged to other borrowers. Similarly, car loans will also be charged 0.25% lower than the usual rate, currently pegged at the Medium-Term Lending Rate (MTLR) of 11.25%. For scooter and motorcycle loans, the rates will be 0.35% lower. SBI normally charges a spread of 0.85% over its MTLR, but for teachers, policemen and judges, the spread will be 0.50%. Effectively, they would be charged 11.75% as against 12.1% for other customers. On personal loans, the spread over MTLR will be reduced to 2% from 2.23%. Effectively, these three special categories of borrowers would be required to pay 13.25% instead of 13.6%.

SBI has tied up with Maruti Udyog Ltd. (MUL) for financing cars at cheaper rates. The loan is provided with a down payment of Rs. 25,000 and equated monthly installments of Rs. 2,500. SBI would be charging an interest of 11.25% which is the lowest ever available to the consumer from any of the financing companies. Besides this, SBI will not charge any processing fees from the customer. Moreover, it has also decided to pass on the subvention benefits to the customers, which a car financing company normally passes on to the dealers or to a direct sales agent.

With an eye on retail market, SBI has also started cross-selling its life insurance arm SBI's life products. IRDA has recently given permission to sell healthcare products to the individuals. Looks like SBI does not want to leave any ground unturned.

Good (bad) strategy?

SBI's home loan PLR could trigger other banks, or may be SBI itself, to follow the same route of having sectoral PLRs, like special PLR for car loans, scooter loans, and so on. So many PLRs can only lead to complications and confusions for the customer, as cannot an individual remember all the PLRs. There are also possibilities of reduction in the relevance of PLR of bank, which is set by RBI.

Source: www.equitymaster.com

Instead, eight to 10 top banks in India, including public as well as private, should form an association and have a common PLR based on which they can decide their lending rate for different segments, on the lines of LIBOR (London Inter Bank Offer Rate). The other banks can select either this PLR or the PLR of banks set by RBI.

Special schemes for doctor, teacher, and justice would mean providing loan at a cheaper rate to the people who may already have a better lifestyle and regular income to pay the interest. Therefore, this scheme would help in minimizing NPA of banks. But, the scheme has a negative side as well. For example, a doctor with an annual income of say, Rs. 5 lakh, and another individual (excluding teacher and judge) earning Rs. 1.5 lakh, wants loan to build a house. However, the question of interest expense-revenue conflict arises as the doctor, in spite of falling in higher revenue bracket, would pay less as interest burden and the person earning less would end up paying higher interest. Then, will the above scheme framed by SBI justify the vagaries of interest burden?

Future

It was expected that the Union Budget 2003 would increase the FDI limit of the public sector banks from the present level of 20% to 49%, but that didn't happen. This could be a huge setback to SBI. An increase in FDI limit would have created fresh funds, which would have helped the bank in its modernization plan. In view of attracting more foreign investments, the FDI limit in private sector banks has been increased (to 74% from 49%) in the present budget. This would mean more competition for the public sector banks, especially for SBI, the largest public sector bank in India. At this juncture, SBI may not like this as it is already feeling the pinch of competition from banks like ICICI, HDFC etc.

Being aware of the threat, SBI is coming up with innovative strategies, which could help the bank in achieving its objective. The bank is also aiming at reducing its net NPA level to 2% by March 2005 from the present level of 4.67% and the gross NPA to 6% from 11.41%; if it materializes, it would help the bank considerably. SBI with its wide network may force other banks to rethink their strategies if they want to survive in the battle. Whoever may win the battle, ultimately, it is the customers who will have a say.

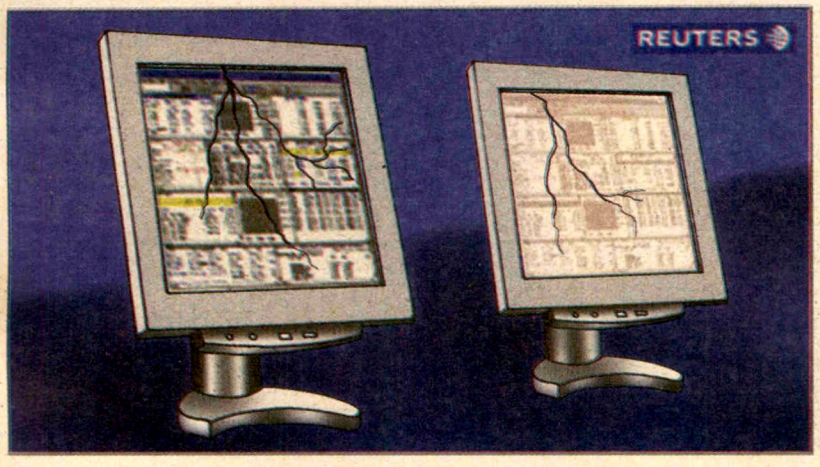
Kunal Singh

Reference # 1-2003-05-06

REUTERS

In rough weathers

A misjudged investment in the form of Instinet, zooming competition, obsolete products and services are all now taking their toll on Reuters, making it look incurably ill.



For the first time in its more than 150 years of history, Reuters, the global giant in the electronic financial-data delivery industry, has unveiled a pre-tax loss to the tune of a £493 mn for the year 2002. While, in no way, this announcement is a cause of concern or panic, the loss was mainly due to the huge write-downs and losses at Reuters' electronic share trading entity, Instinet (which, many consider to be a misjudged investment), which has been struggling to get traded in Nasdaq and is almost at the verge of a collapse. The loss has surprised the analysts who were tracing Reuters for a long time and predicted that the fall of Reuters has started, given the inability of Reuters to quickly respond to the dynamic market's needs.

Till 1996, Reuters dominated the industry with more than 90% share of the industry. With 40% of the world market worth more than $6 bn, Reuters dwarfed Bloomberg, its American rival. But since then, it is Bloomberg, which has been running the show and in the process doubled its market share in a span of a little less than five years (see 'Caught Napping'). Reuters has been constantly losing its market share, both at the lucrative top end and also at the lower end, to its competitors led by Bloomberg. The rapid stock market downturn since the last three years is also adding to Reuters' woes. As a result, Reuters was forced to restructure its business model, which included revamping of its distribution mechanisms, cutting costs and new product introductions.

Problems multifold

Reuters felt the pressure on many fronts since 1997. First, it was the established competitors like Bloomberg, Bridge Information Systems and Dow Jones that were capturing its market share with their unique products. Second, some gaps in its expansion strategies exposed it to further problems. While it was able to succeed in capturing the US trading markets with Instinet, it failed to take a lead in the US screen market, which is also the world's biggest screen market. Reuters' strategies also failed in getting through the booming US mutual fund industry. Third, the inability of the management to respond quickly with new products to face competition. The fourth major threat was from the new-tech upstarts like Moneyline Telerate, Thomson Financial, Caplin Systems and Proquote, who were developing and providing fast news and financial data with extremely low-cost systems that use the Internet to deliver the data. Finally, the investment banks, fund managers and brokerages that form the major constituents of Reuters' customers, have brought down their core area of business, i.e., sales of financial data drastically because of the continuous bear phase in the stock markets. This had a direct influence on Reuters' business revenues. A big mistake that Reuters seems to have committed is failing to realize and leverage the synergies that existed between its various products. Davon Kovelsky, Analyst, *Financial Insights*, observes in this regard, "Reuters appears to have seen a little too late that providing just financial data is not enough. It has expanded beyond raw data to middleware, software applications for risk and trading, and alternative trading systems, but has not created any synergies between them, yet. Each one is in effect, its own company and has been unable to take advantage of an overall Reuters' corporate strategy. Without any overall strategy or synergies between different groups and applications, these applications lose some of their attraction." He continues, "none of Reuters' applications depends on Reuters'

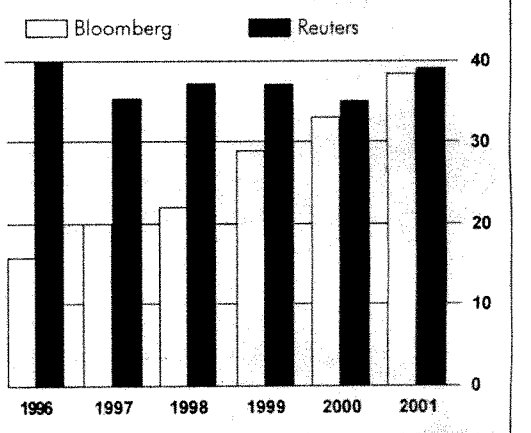
data or information. That is to say that any one's data can be put into them and they will work just fine. It shows Reuters' inability to package the data and applications together in a way that adds value to the data."

Reuters and even Bloomberg offer 'thick client' services to their customers, where the customer has to house a large server computer in his office, while the maintenance and upgradation are done by the technicians from Reuters or Bloomberg. But the new players have developed 'thin client' services, which enable customers to access data on the personal computer anywhere in the world with just a password. The uniqueness of this new service is that the customers need not spend much on the expensive software and hardware because the data is delivered through the Internet. The new players have also broken the tradition of the so-called proprietary data delivery systems offered by the market leaders replacing this with much cheaper Web-based services. This massive shift brought out by the Internet meant that data no longer need to be transmitted over proprietary data delivery systems owned and operated by Reuters and even Bloomberg. The new players have developed both back-end and front-end data delivery systems that allow their users to have access to almost 90% of the Reuters' data through a Web browser. Even Reuters provides the same data, but the difference is that the new entrants provide it at half the cost.

While the newer entrants in the industry pulled off the market from Reuters at the lower end of the market, by offering quality services with cheap prices, at the top, it was Bloomberg that has done the damage with its unique placing and pricing of products coupled with some savvy marketing strategies. Bloomberg sold one product (which in itself is a combination of many services) at a single price unlike Reuters, which sold many products at different prices. This made the big difference for Reuters. During boom periods even though traders preferred to operate with both the services of Reuters and Bloomberg, in downturn, most of the traders chose to go with Bloomberg because of the cost efficiency.

Caught Napping

Global market share by revenue, %



Source: The Economist, February 20, 2003

Reuters also faltered at providing effective product-based services. This is because of the fact that, given the nature of the clients who use the information, like investment banks and research firms, the data should be of utmost quality and should be immediately delivered. The product portfolio offered to its clients by Reuters is so obsolete and outdated that customers no longer find it indispensable. Also, as the number of trading positions is reducing day by day coupled with declining volumes, the banks have no option except to cut down their costs on their financial data procurements and go for cost-effective and latest alternatives. Hence, they started switching towards other data providers, for their daily financial data needs. This is quite obvious from the fact that in the year 2002 alone Reuters lost around 100,000 terminals to 493,000 which is almost 18% less when compared to the previous year. Even though, Reuters still enjoys terminals thrice that of Bloomberg, the average revenues from them are hardly a third of what Bloomberg earns through its terminals. This in itself is an indication that the top-end customers are no more willing to continue their contracts with Reuters. Another major factor, which reflects this trend, is that recurring revenues were down by more than 5% in 2002.

Diversification into businesses, where it does not have any competitive advantage further added to its woes

The ever exploding information technology revolution, the phenomenal reach of the Internet and consolidations between the financial firms worldwide because of economic downturn have only increased the problems for Reuters, resulting in the cancelation of many of its contracts. The diversification into businesses, where it does not have any competitive advantage like, IT consulting and providing Enterprise Software Solutions, further added to its woes. This diversification has only resulted in huge costs and Reuters became, as the saying goes: Jack of all trades and master of none.

While all these external factors resulted in Reuters' loss, much of the blame goes to its top management because of their inability to take right and quick decisions at the right time. In the words of Tom Glocer, CEO, Reuters, "the culture of Oxford debating society" prevailed in Reuters. New services were not introduced when they were in demand, like the case of introducing Reuters' instant-

messaging system. It was introduced only in October 2002, even though Bloomberg introduced it long back. By such actions, Reuters failed to cash on its products when they were in demand. The management appeared as if it was inept at identifying and excelling on the skill sets that are required for survival as the industry matures over a period of time. Of course, all this was under the management of ex-CEO, Sir Peter Job, till mid-2001, and he was later replaced by Tom Glocer.

Restructuring

After the takeover of the top management by Tom Glocer, a five-year, five-point plan was designed called as 'Fast Forward' strategy. Carried in two phases, the plan in the first phase focused on cost controls and reshaping of the business. The plan was also designed in such a way that the inherent market forces like cyclical, competitive and structural were attended to. As a part of responding to competitive forces, Reuters introduced new products like 3000Xtra and its instant messaging service. But as discussed earlier, these were outdated by the time they were introduced. The key strategic initiatives of Fast Forward were: 1) Making Reuters' information indispensable 2) Take advantage of Reuters' global presence by moving to a single, scalable data distribution mechanism 3) Developing rigorously segmented product line 4) Focusing on core competencies and 5) Reducing the cost base. On its way to expand its business, based on its core competencies, Reuters decided to enter into equity research business and also acquired Multex, a US base equity research firm. It is to be seen how effectively Reuters implements this strategy. "Can this strategy package and integrate its various applications and data streams in such a way that end-users will feel that they can have an intuitive level of understanding of the product?" questions Kovelsky. He asserts that if Reuters can achieve this, the financial institutions will start to purchase and keep it, no matter how the economic cycle takes its turn.

As a part of responding to competitive forces, Reuters introduced new products like 3000Xtra and its instant messaging service

Out of the above five initiatives, the only one which has been effectively implemented so far is cost-cuttings, though much of the cuts were done through downsizing. Another cost-cutting measure announced was to walk out of the peripheral consulting businesses and shedding out nearly 56 non core investments. The goal is to save at least £440 mn a year in two years time from now.

Uncertain future

While the sincerity of Reuters' top management in bringing back the company to its heydays is appreciable, the old culture of the typical bureaucratic style still dominates much of the decision-making process. With such a type of system in place, it would only be an exaggeration to say that Reuters would be able to strike back with new product innovations and aggressive marketing strategies. Huge resistance to changes from the old-timers inside Reuters is another factor, which is not allowing Glocer to proceed in his attempts to turnaround Reuters faster. As *The Economist* rightly points out, "Against such cultural inertia, the best he may be able to do is to stave off decline, but Reuters will be a shadow of its former self."

Having said this, one cannot ignore the fact that there will always be a need for financial information providers, given the various constraints that financial services firms face in collecting the required data. The only point is how cost efficiently the information providers supply the information. Kovelsky says, "What these companies must do is provide value-added services to complement the data and at the same time lock the customer in. Bloomberg has done this masterfully: By making a conscious decision to base its revenues on the number of terminals it sells and permits anyone who has a terminal to use all the available data, and it has become and remains a must have. While doing so Bloomberg has ensured that its terminals become a necessary part of the traders' lives, thus Bloomberg remaining strong." This is what had enabled Bloomberg to dive past Reuters in a very short period of time. But then a word of caution for Bloomberg: Since it employs almost the same business model as that of Reuters, there is every possibility that it also would finally go through the same fate as that of Reuters, if it does not change its technology platform from that of the proprietary data delivery systems!

> **"If Reuters is to continue to compete against Bloomberg directly, it must find something that banks will pay for beyond the data and which will keep its presence in a turret."**
>
> **Davon Kovelsky**
> *Analyst*, Financial Insights
> *Cambridge*
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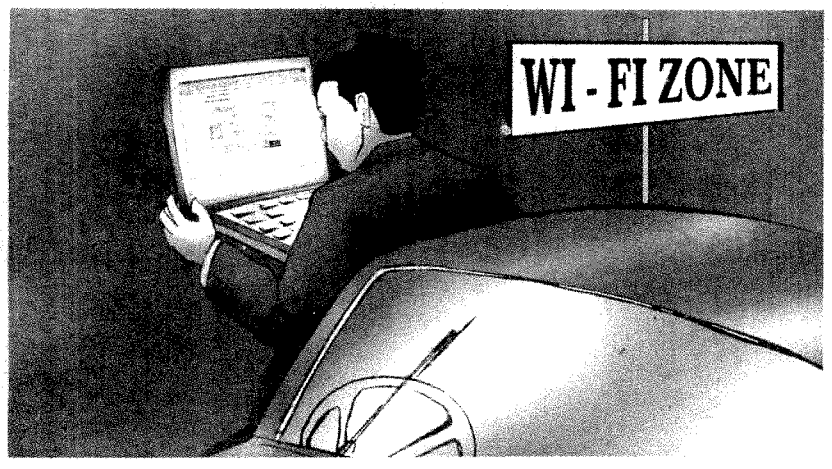
Ramakrishna Neti

Reference # 1-2003-05-07

WI-FI

Unwiring the Web

Thanks to the technology called 'Wireless Fidelity' or 'Wi-Fi', mobile Internet will soon be a reality for millions of surfers across the globe.



It is the 'hot spot' on the technology landscape. And, going by its stellar growth during the last two years or so, it may probably be the next big thing in the technology arena. It is Wireless Fidelity or Wi-Fi in short. Unlike its predecessor i.e., Bluetooth, which too promised to make wireless Internet a reality but failed to materialize until now, Wi-Fi has been gaining momentum with strong backing from technology bigwigs. Companies like IBM, Intel, and AT&T have joined hands to offer Wi-Fi services at 10,000 locations or hot spots, as they are popularly known as, in America. Besides, a host of stand-alone players or Hot Spot Operators (HSO), have already set up their shops in the US. Similar partnerships are being formed in Asia and Europe as well to provide Wi-Fi services.

The idea of a hot spot, at places like restaurants, airport lounges, cafés etc., sound quite exciting; companies such as McDonald's and Starbucks have already started offering Wi-Fi to their customers in some of their stores. Notwithstanding such initial enthusiasm, some glitches remain to be removed.

The emerging dominance

Despite initial glitches, owing to slow transmission speed, and a slow beginning about five-six years ago, the Wi-Fi technology has finally found a foothold in the growing wireless services market. The factors that have contributed to the growing acceptance of technology among the technology developers as well as users are low entry barriers, an open architecture, speed and added to it, the lack of any regulatory constraints; all ingredients of success for a technology, success of Linux would vouch for it.

According to Boingo Wireless, Inc., a leading player in the Wi-Fi space, HSOs enjoy a very low barrier to entry. Today, installation costs for Wi-Fi equipment has fallen to less than $200, for a small installation, compared to $500-600 a couple of years ago. Larger hot spots require additional equipment, antennae, and faster connections such as T1 lines. Still, it says, the cost of establishing a hot spot is lower than setting up a cellular node—Wi-Fi uses unlicensed spectrum vs. licensed spectrum that can cost billions of dollars, and the equipment necessary to set up a hot spot costs hundreds of dollars vs. hundreds of thousands or millions in cellular. Wireless LAN (WLAN) operates on unlicensed airwave spectrum, unlike Global Standard for Mobile Communication (GSM) technology used by cellular operators, which further reduces the cost for a broadband connection. Another factor that is contributing to the growth of WLAN is the same which helped make PC a household product—commoditization. According to Boingo, Wi-Fi components are now on a consumer adoption price curve. Rapid commoditization of Wi-Fi components has triggered steep declines in the price of Wi-Fi equipment. APs (Access Points or Wireless Hubs) were over $1,000, but are $100 today, and Wi-Fi cards that were $700 are now regularly sold for less than $50.

Also, it is easy to install as most high-end laptops now come ready for Wi-Fi, equipped with a special plug-in circuit card.

A World Markets Research Center (WMRC) report also vindicates this. It says that minimal investment from an operator plus support from chipmakers has done much to encourage the creation of WLAN 'hot spots', as integration with wireless standards heralds a technology flexible in its deployment. Intel, the world's leading chipmaker has already announced its support to wireless technology.

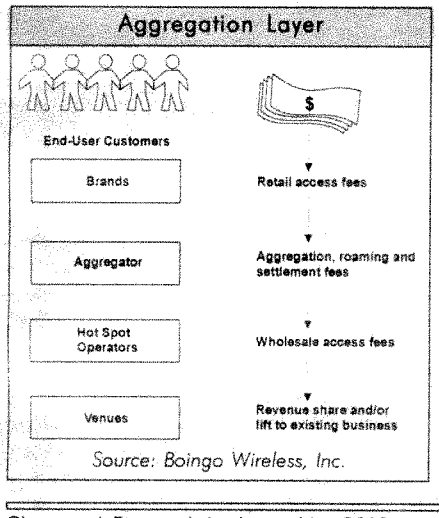
As technology has evolved over the years, more and more users find it convenient to move around their

workplace or home without the need of a physical LAN (Local Area Network) connection. 802.11b or Wi-Fi has emerged as the most popular inexpensive networking standard that uses an unlicensed portion of the radio spectrum, although, of late, some new standards like 802.11g and 802.11a have also come in vogue. For the last two years, Wi-Fi has been a dominant standard for WLANs worldwide. Anyone can set up a Wi-Fi network and cover an area of typically 100-500 feet with Internet access which is hundred times faster than a modem connection. Wi-Fi is an open-standard technology that enables wireless connectivity between laptops and local area networks. Today's Wi-Fi products, which transmit in the unlicensed spectrum at '2.5' GHz, are capable of speeds of up to 11 Mbps which is 100 times faster than a modem connection. Further, it is significantly faster than the '2.5G' wireless services provided by cellular carriers, which typically deliver throughput between 40k and 60k.

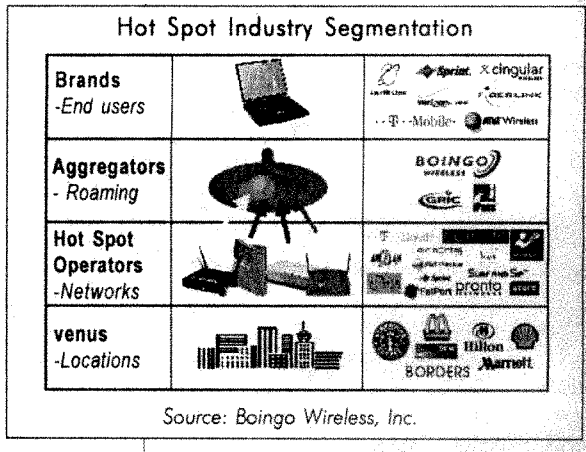
Compared to competing technologies like much-hyped Bluetooth and lesser-known IrDA, which promised to offer similar services, however, have not been able to garner much support.

The hot 'hot spots'

During the last couple of years, the hot spots have seen phenomenal growth in USA. According to the market research firm In-Stat/MDR, hot spot market recorded tremendous growth particularly during last year. Around 3,700 for-pay Wi-Fi hot spots were set up in the United States by the end of last year with 2,600 of them in coffee shops. And, that number, the research firm says, is expected to explode to 10,000 by the end of this year. During the same period, worldwide hot spot footprint grew from 2,000 locations to over 12,000 locations, as per the firm's report.



Source: Boingo Wireless, Inc.



Source: Boingo Wireless, Inc.

According to Boingo, in the last two years, dozens of new companies set up hot spots in cafés, hotels, airports, bookstores and other public places. These HSOs like Wayport, Surf and Sip, and Deep Blue to name a few, install Wi-Fi access points and then turn around and sell high-speed wireless Internet access for a fee. In fact, in the last one year or so, many major wireless carriers have also thrown their hat in the ring, that includes Cometa (a joint venture between AT&T, IBM, and Intel), which offers Wi-Fi services at McDonald's select restaurants, and T-Mobile, which is building hot spots in Starbucks cafes, Borders book stores and airline clubs, among others.

Anyone can set up a Wi-Fi network and cover an area of typically 100-500 feet with Internet access which is hundred times faster than a modem connection

Is the strong growth in hot spots a sign of bright future for the wireless Internet? It would not be easy to take a stand at a time when technology is still evolving. Yet one thing is clear that it does stand a fairly good chance of taking a lead over rival technologies. David Farber who is a strong supporter of Wi-Fi offers good insights. He argues the biggest change is that it (Wi-Fi) allows for a lot more creativity. For years, the use of wireless industry has been regulated. You had companies that bought spectrum space, you had cellphone companies that sold handsets, but there was very little opportunity to get the innovation that came from getting a large number of people to work at finding different ways to use wireless technology. Wi-Fi facilitates that. Another factor in favor of Wi-Fi, compared to its rival technologies is that it's a bottom-up technology. Paul Boutin, Technology Analyst, Slate, Wired etc., says, "Rather than waiting for the phone company to roll it out, individual people and entrepreneurs can set it up themselves, without government licenses. We don't need to go to a store and wait around for an employee to sign us up, and hope they sold us the right product and service plan. We can get going all by ourselves. And in most cases, there are no hidden fees to surprise us later. Wi-Fi feels like a club we join, rather than a utility for which we are billed by an enigmatic monopoly."

However, despite such optimism, several issues remain unresolved. One of the major hurdles before the technology

players supporting Wi-Fi is the fragmented nature of the hot spot industry, which leads to lack of unified or universal roaming facility. To overcome this, Boingo suggests that the industry could learn a lesson or two from the cellular telecommunications industry. Wi-Fi has an accessability range of 100-500 feet. This means that in the future, as a subscriber walks down the street past a café, a bookstore and then a hotel, he or she might encounter three different hot spots. It says that like the early days of cellular and ATMs, there is lack of unified roaming in Wi-Fi that holds back the industry. Far fewer people used ATM cards when they were only accepted at the issuing bank's locations. Similarly, cellular adoption only took off when people could roam from area to area and were not required to change phones and providers. Wi-Fi users today, it says, are forced to either maintain accounts with each of the hot spot operators they encounter in their travels or type in their credit card number each time they want to connect. As hot spots proliferate, fragmentation will only increase the problem. Until there is unified roaming across all hot spots, industry growth will be hampered, the solutions provider argues.

One of the main reasons GSM usage bloomed in Europe and around the world may become the solution to a current WLAN hot spot problem, it says. GSM really took off in Europe after wireless carriers got together and hammered out roaming agreements so that subscribers could use their phones in Finland, Sweden, Great Britain, France and anywhere else they wanted to travel. Until those agreements were in place, GSM networks had only local utility. Now, most of the world uses GSM. It is not too big a stretch to apply the same formula to 802.11b Wi-Fi access. Most companies in the Wi-Fi industry understand that public hot spot access has to be widespread for the technology to have mass-market appeal. But solutions have developed slowly, says the solutions provider.

Another concern is the lack of focus on part of the HSOs. Boingo suggests that the ISP (Internet Service Provider) industry offers some useful insights in that regard. It says that Wi-Fi hot spots are going to be a big business, and one company can't possibly provide all the components necessary for success by itself. The short range of Wi-Fi networks means that, even with billions of dollars to spend, one company can't build all the hot spots necessary to meet the ubiquity demanded by customers. As was discovered in the wireline ISP space, it is also difficult to be successful both at building and operating networks and servicing and supporting end-users, or have vertical integrated business model. They are two different skills, says it. With low entry barriers it would be difficult to stop proliferation of players covering the entire value chain, which could make survival

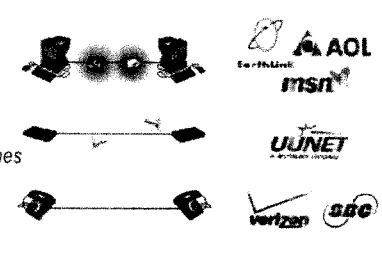
Wi-Fi – At a Glance

Wi-Fi (Wireless Fidelity) technology allows one to connect to the Internet from home, hotel room or a conference room at work without wires. How? Wi-Fi is a wireless technology like a cellphone. Wi-Fi enabled computers send and receive data indoors and out; anywhere within the range of a base station. And the best thing of all, it is fast. In fact, it is several times faster than the fastest cable modem connection. However, one only has true freedom to be connected anywhere if his or her computer is configured with a Wi-Fi certified radio (a PC Card or similar device). Wi-Fi certification means that a user will be able to connect anywhere, where there are other Wi-Fi certified products—whether one is at home, office or at corporate campus, or in airports, hotels, coffee shops and other public areas equipped with a Wi-Fi access available.

Wi-Fi networks use radio technologies called IEEE (Institute of Electrical and Electronics Engineers) 802.11b or 802.11a to provide secure, reliable, fast wireless connectivity; 802.11 refers to a family of specifications developed by the IEEE for wireless LAN technology and specifies an over-the-air interface between a wireless client and a base station or between two wireless clients. A Wi-Fi network can be used to connect computers to each other, to the Internet, and to wired networks (which use IEEE 802.3 or Ethernet). Wi-Fi networks operate in the unlicensed 2.4 and 5 GHz radio bands, with an 11 Mbps (802.11b) or 54 Mbps (802.11a) data rate or with products that contain both bands (dual band), so that they can provide real-world performance similar to the basic 10BaseT wired Ethernet networks used in many offices. Everyone can use Wi-Fi, almost everywhere in the world. Home Wi-Fi networks can connect multiple computers to each other, to peripherals, and to the Internet. A Wi-Fi network can connect a family's computers together to share such hardware and software resources as printers and the Internet. A Wi-Fi network can easily be expanded to 10 users or more.

Compiled from Wi-Fi Alliance, a non-profit international association formed in 1999 to certify interoperability of wireless Local Area Network products based on IEEE 802.11 specification.

ISP Industry Segmentation



Source: Boingo Wireless, Inc.

difficult. Hence, the industry could go for segmentation, with each group of players covering a particular layer (see the table: Hot Spot Industry Segmentation).

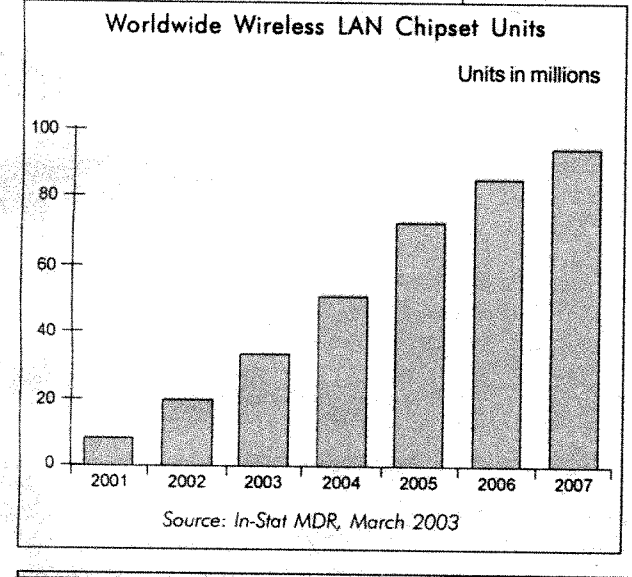
The slow growth in the user base too poses a serious challenge to the hot spot industry players, besides certain other issues like security breach in Wi-Fi's encryption protocol, congestion, and interference. According to In-Stat, although there has been phenomenal rise in the hot spot locations, this has not translated into a significant increase in usage of those locations. It suggests that companies that are building wireless networks for their customers need to educate the public that the hot spots exist and show people how to use them. Boingo goes a step ahead and suggests that HSO should install software which acts as a 'sniffer' so that a user does not have problems in connecting to the Internet.

A promising future

If laptop fueled the growth of Wi-Fi in the first phase, in the second phase, it would be cellphones, if In-Stat's forecasts were to be true. The current giant application is the laptop, perhaps the original wireless LAN application that started it all, says the research firm. Both Intel and Microsoft want to see wireless LAN included in all new laptops sold, and all indications are that soon it will be. The research firm projects that by the end of next year, over 70% of new laptops purchased will come with some type of integrated wireless LAN support. The second, potentially giant, wireless LAN application, the firm says, is wireless LAN embedded in a cellular handset and used for Voice-over-Internet Protocol or VoIP. While this application is still in its infancy, the potential for hundreds of millions of wireless LAN chips is certainly present, it suggests.

For now, it is the McDonald's and Starbucks who have the onus to take Wi-Fi to the common surfer. The leading US restaurant chain installed Wi-Fi access points in 10 of its restaurants in Manhattan as part of a pilot program. And, it further plans to wire 300 more stores by this year end. Starbucks, the US-based café major has equipped 530 of its stores with Wi-Fi and plans to enable more than 70% of its 3,200 outlets.

However, any future growth of Wi-Fi may come at the cost of another competing technology 3G, popular among cellular operators globally. The WMRC report says that the WLAN market is growing strongly worldwide as 3G services stutter towards launch. Though a section of experts do not agree with this notion. David Farber, professor of telecommunications at the University of Pennsylvania and networking expert has opined "though through Wi-Fi one can get higher speeds than from 3G (third generation technology used by cellular operators), there are places where 3G works and Wi-Fi doesn't. Farber suggests that initially" Wi-Fi will have an impact on the growth of 3G; however, the latter has applications to survive. In defense to this argument he states that it might not be a workable idea to put in a nationwide Wi-Fi network, as there are better ways to do that. Wi-Fi works very well in a relatively dense population, but it is never going to cover a lonely back road. And ultimately, Wi-Fi may create more demand for 3G, he observes.



> **The biggest problem to be overcome is lack of range, and the resulting lack of footprint (i.e., available coverage area),**
>
> **Paul Boutin**
> *Technology Analyst*
> *Slate, Wired,*
> The New York Times
> *USA*

The history of technology suggests open architectures, which gained momentum, there were no looking back for them; Linux is the best example of that. The ensuing commoditization process would ensure that rivals are taken care of. As *Fortune* commented, "Wi-Fi has all the makings of a pervasive, explosive technology: Huge growth, a strong value proposition, multiple and expanding uses, industry standardization, and global standardization. The technology's flaws are nothing more than a speed bump, given the billions of dollars of R&D already poured into this space." It is hoped Wi-Fi protagonists would cross those bumps.

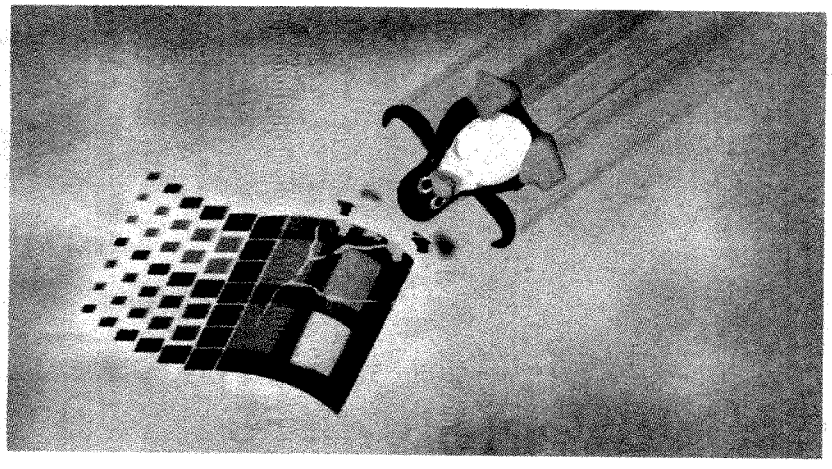
Amit Singh Sisodiya

Reference # 1-2003-05-08

MICROSOFT vs. LINUX

Gaining traction

The emergence of Linux as an alternative to Windows operating system is changing the nature of competition in the IT industry. It is time now for Microsoft to employ innovative strategies to counter the threat.



Five years ago in 1998, the then President of Microsoft, Steven A Ballmer (Ballmer) referred Linux as 'lie-nucks.' Bill Gates often referred Linux as the creation of 'hobbyists'. During that time, Linux was just another operating system, a newer version of the existing Unix operating system, which was the work of thousands of anonymous hackers choreographed by a young Finnish student called Linus Torvalds. The most interesting part was that Linux could be downloaded free from the Internet. Most of the people associated with Information Technology (IT) industry who were skeptical about the success of Linux, never thought that one day it would become a serious rival to Microsoft—the Goliath of the software industry.

However, it looks like they were all wrong. Linux, once the symbol of software's counter-culture, has now become the mainstream technology. From a zero market share three years ago, Linux has grabbed 13.7% of the $50.9 bn enterprise server market in 2003, and according to the market research group, International Data Corporation (IDC), Linux is predicted to grab 25.2% market share by 2006. Compared to Linux, Microsoft's share in the enterprise server market is being predicted to decrease from its existing 59.9% over the next three years. Not only that, Linux is also being used in a big way in consumer electronics, like video game consoles; digital animation; corporate computing for running data centers; supercomputers for mission critical operations; simulation; and in desktop computing. Microsoft is also experiencing a big threat from unexpected quarters. The big IT companies like IBM, HP and Dell are embracing Linux in a big way. All these events have posed a big threat to Microsoft's hegemony in the operating system market, such that Ballmer, now the CEO of Microsoft, recently admitted Linux as the 'threat number one'.

The changing competition

Five factors have helped Linux to emerge as the alternative to Microsoft's operating system. First, due to the recessionary condition prevailing in most of the economies in the world, companies are under immense pressure to reduce their costs including their IT infrastructure costs. Linux is a free software, which according to Professor Eric von Hippel, MIT Sloan School of Management means, "a user may obtain a copy at no cost and then legally stuff its source code, modify it and distribute it to others also for free." A software author uses his or her own copyright to guarantee those rights to all users by affixing to the code a standard licensing notice, such as the General Public License (GPL). "Instead of spending millions of dollars on expensive high-performance computers, Linux users spend a fraction on the hardware and operating system and use the savings to create very powerful specialized software.

In contrast, companies who use Microsoft's propriety operating system, pay huge amounts in licensing fees. Recently, Microsoft has also changed its licensing program. Under its new licensing program customers have to buy software and also lock in to upgrade the software every two years. According to the market researcher, Gartner, the new program would raise prices between 33% and 100%. Microsoft has also incorporated into the contract with contingencies that compel customers to switch to the new maintenance deal sooner rather than later. As a result, companies have found Linux as an ideal low-cost alternative, which made many small businesses and few countries such as Germany and China to opt for Linux as the

operating system in their Web servers and desktop computers. Several computers with Linux operating system could also be 'clustered' together to create cheaply a machine with the power of a supercomputer.

Second, Intel, the dominant maker of processors for PCs, has also started to optimize the Linux operating system, used in desktops and servers, so that Linux could take advantage of the graphics capabilities and processing power of Intel's Pentium II processors. This has made it possible for corporations to get all the computing power they wanted at a fraction of the price. In the late 2001, Intel persuaded software makers such as storage specialist Veritas Software and financial information providers such as Reuters to switch over to Linux from Windows.

Third, companies from both IT and non-IT industries had a grudge against Microsoft. Microsoft's Windows operating system has a 90% market share in desktop PCs, and is the No.1 in the enterprise server market. Its competitors accuse Microsoft of using its monopoly over computer operating systems to obtain more market power by bundling its products free, such as Internet Explorer with its operating system, thereby thwarting products of other companies to enter the market. Its customers fear that Microsoft had a noose around their necks through its proprietary software. All wanted to break free from Microsoft's stranglehold.

Fourth, the willingness of the major IT companies to support and maintain Linux systems has also helped to convince other companies. As a result, Wall Street brokerage firms, like Morgan Stanley, Goldman Sachs, Credit Suisse First Boston, and E*Trade, have embraced Linux as a viable platform.

From IBM, HP to Dell, all have jumped on to the Linux bandwagon, offering computers with the program pre-installed and investing in Linux companies. IBM embraced Linux in 1999, and now offers it across its entire range, from PCs to mighty mainframes. IBM has spent around $1 bn on Linux-related activities in 2001. Linux has also boosted IBM's mainframe business, since a single mainframe can be set up to behave like dozens of small Linux servers. Linux also provides IBM an opportunity with an operating system that unifies its different software products. Oracle also supports Linux for its database services and has customers successfully deployed on Linux. Germany, Japan, India, China and a number of others have the initiatives to move some or all of their federal systems to Linux.

From IBM, HP to Dell, all have jumped on to the Linux bandwagon, offering computers with the program pre-installed and investing in Linux companies

Fifth, post September 11, security has become the top priority for the companies. However, security is one area in which Microsoft has fallen well short of the mark. Windows has become the preferred target for computer viruses. In June 2002, Microsoft had to post three advisories for 'critical' security flaws affecting its Windows NT and 2000 servers. Servers running Linux are generally more secure and in addition Linux is also reliable and stable. Linux is also a multi-user system while Windows is not.

Threats to Linux

There are certain issues, which might derail the juggernaut. The biggest threat is intellectual property issues. SCO Group, holder of the original patents for Unix software, upon which Linux is based, has announced plans to form a licensing division and hire lawyers to press claim against sellers of Linux. Another problem is that till now there are different commercial versions of Linux. Lack of an industry standard would force software companies that sell Linux applications to create a separate version of each type of Linux. For companies buying Linux, this would increase costs.

> **Linux still has to develop a stable and easy interface with many software products.**
>
> **Professor Bruce Kogut**
> *Strategy and Management*
> *INSEAD, Fontainebleau*
> *France*

In addition, most PC users know almost nothing about Linux, and Windows is much more easier to use compared to Linux. Professor Gerald R Faulhaber of Wharton Business School commented in the article *Linux: Will it Ever Smash Windows*, "Linux people have to make it easy to go from Windows to Linux, just like Microsoft made it easy to go from DOS to Windows." For a long time, the Macintosh operating system was better than Windows, yet it never unseated its rival. Linux, like Macintosh, must deal with the 'applications barrier'; thousands of programs run on Windows, like Spreadsheet and MS Word, but not on Linux. Unless and until Linux proponents develop means to make it possible for the customers to readily use the Windows applications on the Linux system, the economic value to shift from Windows to Linux will be negative. Professor Bruce Kogut, Strategy and Management, INSEAD, Fontainebleau, also agrees. According to him, "Linux still has to develop a stable and easy interface with many software

products." Microsoft also spends huge amounts on promotion and marketing of Windows, which dwarfs the efforts of the Linux proponents.

On the other hand, Red Hat, and other big open-source companies have attached increasingly restrictive conditions to the use of their software packages and the proprietary add-ons they control. Such restrictions could hinder the growth of Linux, since the primary reason for many of the companies purchasing open-source software was to avoid the hassle of licensing. These companies have also increased the prices of their high-level packages of Linux server software. Such increases have also increased the initial purchase costs of Linux close to that of Windows.

Microsoft's answer

From the time when Linux started replacing Unix operating system in the high-end enterprise servers segment, Microsoft became worried about Linux. In the article *Microsoft Memo Touts Linux* written by Ricciuti Mark, Vinod Valloppillil, a Microsoft programmer, commented, "Linux represents a best-of-breed Unix, that is trusted in mission critical applications, and due to its open-source code has long- term credibility which exceeds many other competitive operating systems." In the same article, it was also mentioned that Microsoft considered Linux to be a threat on both server and desktop markets. However, publicly Microsoft never acknowledged Linux's popularity. In 1999, Jim Ewell, Marketing Director for the next generation of NT, called Windows 2000, commented in the *BusinessWeek*, "(Open-source) is more of a public relations phenomenon. I don't think we or our customers need open-source right now." Ed Muth, the group product manager for Windows 2000 also had the same opinion. According to him "Linux is just another brand of Unix, and I don't think the world is crying out for another Unix operating system."

Microsoft took the battle further, by creating a website under the heading 'Linux Myths' that questioned the performance and reliability of Linux. Unable to contain Linux's surge, in 2001, Microsoft's top executives spoke about the evils of free software in public forums. Craig Mundie, Microsoft's Chief Software Strategist, cautioned the companies about the perils of open-source software. He accused that the GPL that comes with most of the open-source code could turn a company's intellectual property into a public good. In addition, it undermined the livelihood of commercial software developers, putting a brake on innovation.

As Linux gained more acceptance in the corporate world, Microsoft changed its tactics and stopped speaking about the evils of free software in public. Instead it is now openly acknowledging that Linux was indeed eating into its market share. In the article *Ballmer: We'll Outsmart Open-source* written by Judge Peter, Steve Ballmer, CEO of Microsoft, commented, "Linux is a serious competitor. We have to compete with free software, on value, but in a smart way. We cannot beat them on price, but we have to add value. Linux will not go away, our job is to provide a better product in the marketplace. There is more to Linux than free software; the main benefit of the open-source movement was the community developing software and sharing ideas. Linux is not about free software, it is about community."

At the same time, Microsoft has also adopted an 'embrace and extend' strategy. Under this strategy called Shared Source, Microsoft now grants its largest customers access to the source code of Windows 2000, on condition that they would not modify the source code or reuse it. However, this new strategy looked very much like one-way sharing, because customers could look at the source code of Windows, inform Microsoft about bugs and suggest improvements, thus saving Microsoft a lot of money, but they still have to pay for the next version. Microsoft is also planning to extend its shared-source initiative to 'Most Valued Professionals (MVP)'. The MVP initiative would be Microsoft's efforts to promote a sense of 'community' among users and developers, connecting its own product developers with the users who are most in touch with product issues. Currently, there are about 1,200 MVPs, and half of them are in the US.

To slowdown the acceptance of Linux by governments in various countries, Microsoft has aggressively lobbied the various governments to expand their purchases of Microsoft software. Microsoft has announced that it would open the source code of Windows operating systems with the governments. The company would also allow governments to plug their own security features instead of Microsoft's features into Windows. However, Prof. Kogut is skeptical about its success. He says, "Linux is spreading through the science community, and the government is part of this community."

Microsoft is now trying to emphasize the business benefits of its software, i.e., total cost of ownership of software. Microsoft argued that it is expensive to maintain Linux compared to Windows on computers. In support of its argument, Microsoft has recently commissioned a study by market research group, IDC, which gave the verdict in favor of Microsoft. The study concluded that because Microsoft had created more software tools for managing and updating Windows, the operating system would be 11% to

22% cheaper to run compared to Linux over a five-year period in four out of five different common computing tasks like sending files to printers and running security applications. However, for the Web servers, Linux has a cost advantage by 6% over Windows 2000 over a period of five years. Microsoft is committed to reduce resource requirements and lower acquisition costs for its customers with the release of Windows Server 2003.

But Professor Brian Fitzgerald, Frederick A Krehbiel II Chair in Innovation in Global Business & Technology, Department of Computer Science and Information Systems, University of Limerick, Ireland is skeptical about such studies. According to him, "This, like (other) studies that show Linux is cheaper, must be taken with a grain of salt. You can get studies to show whatever you like. The Fuzz papers are often used to show that Linux is more reliable than MS Windows, but depending on how, which results you choose, you can also illustrate the reverse."

In its effort to discourage the small businesses customers from switching over to Linux, Microsoft has unveiled a new policy, called Open Value under its new licensing program. According to the policy, Microsoft's sales representatives can request for steeply discounted pricing for the small business customers from Microsoft's superiors. The plan also allows small businesses to spread out payments over three years while still staying current with the latest Microsoft releases. In addition, Microsoft is also offering zero percent financing under its new licensing program for its small business customers.

Prof. Fitzgerald agrees with the policy of aggressive pricing. For the governments of emerging countries like China and India, cost is an important criterion for selecting a software. Government agencies and officials in China and India have expressed support for Linux, which is much cheaper than Windows. However, low cost alone is not the motivating factor for favoring Linux. The open-source code is also a powerful incentive. Microsoft had long guarded source code of Windows, and that has become a sore cultural point for some Chinese, who have their suspicions about the trustworthiness of the American giant.

On the other hand, Microsoft has also created linkages between PCs and other consumer appliances by developing variations on Windows like Windows CE, for a variety of digital devices like personal digital assistants, its new Tablet PC, and Xbox. This strategy would expand the market for Windows.

Conclusion

Microsoft had tried to ignore Linux, it failed, it is trying to capitulate Linux by sharing some source code with its big customers and opening the source code of Windows software for government agencies. Prof. Kogut opines, "(In the past) Microsoft prevailed over Netscape by giving away its browser and increasing the appeal of its other products with Internet-embedded features. Linux challenges the operating system and hence this earlier strategy will not work." However, this strategy may not be fruitful. The better option would be to co-opt Linux and what Prof. Kogut says, "Microsoft will have to push innovation." In today's hyper-competition, co-option has become a strategic move for some companies. By opening the source code of Windows to all which Prof. Kogut agrees and offering it free and developing software applications, which are compatible with both Linux and Windows, Microsoft could ensure its dominance and at the same time be able to stem the popularity of Linux. It would also spur innovation. Market researcher, META Group had recently predicted that in a major strategy shift, Microsoft would introduce software based on the Linux open-source operating system in 2004 for Web services and server software.

> **If Linux continues to increase its market share at the current rate, it obviously will topple Windows to become the world's number one operating system in the distant future.**
>
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However, this means a change in the business model of Microsoft. Instead of making money from selling software products, the company has to build businesses around selling services, what IBM does now or create software that runs on top of Linux, like Oracle. It seems that time is soon coming for Microsoft to change its business model. Prof. Kogut thinks, "a mixture of private and public software will allow for earnings from intellectual property."

To conclude, Prof. Kogut opines, "(Linux) will perhaps be able to topple Windows as the number one operating system in certain countries over the next few years, but globally, it will not. However, in the longer run, it might." Prof. Fitzgerald says, "If Linux continues increasing market share at the current rate, it obviously will (topple Windows to become the world's number one operating system) in the distant future."

Anindya Roy

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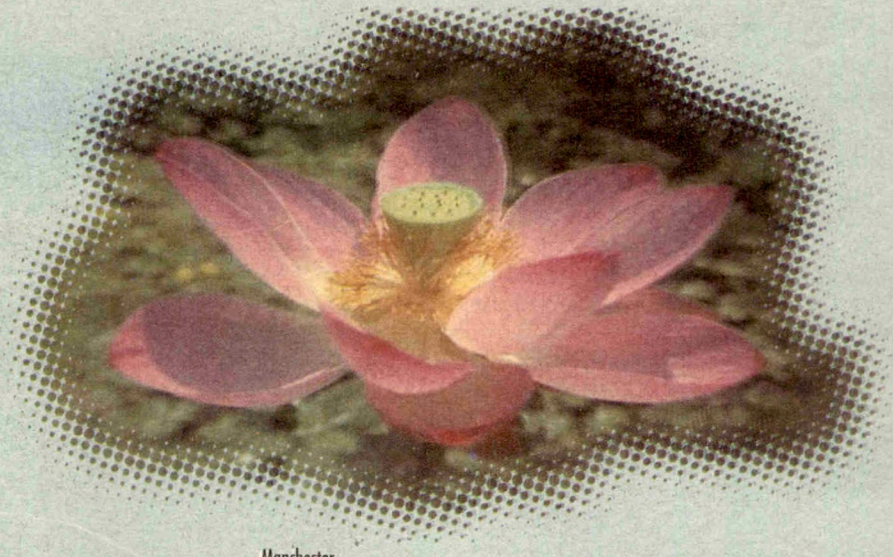

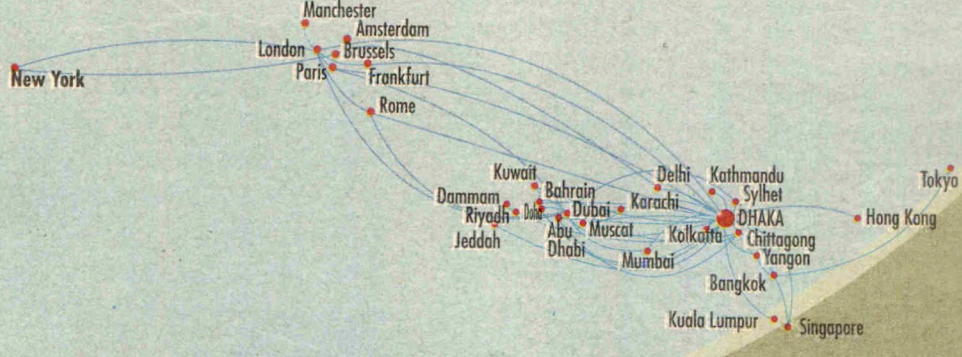

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TATA AND RELIANCE

Setting a trend?

What fascinates a company to provide cellular and WLL service in the same circle? Will it become an industry trend?

The liberalization of the telecom sector has ushered in a new phase in the history of Indian telecommunications sector. Not only it has enabled the entry of private players but also brought in new technology. In 1995 private players started providing cellular service with GSM technology. Since the technology factor has facilitated premium services by private players, cellular services were limited to a small section of the Indian society. In order to extend the cellular services to the populace at large, service providers came up with Wireless in Local Loop (WLL) with CDMA technology. This has revolutionized the Indian telecom industry and is proving to be a cash cow for service providers. But the presence of WLL has bought in a lot of controversies and uncertainties for the other telecom companies.

The presence of WLL in the market has forced major players to change their strategies. Until recently, Telecom companies in India have focused on either offering cellular or WLL along with fixed line services. But now, a third category has emerged where companies have started venturing into all three modes of communication i.e., cellular, fixed line and WLL. Tata and Reliance are the two companies, which fulfill all the requirements of the third category. The peculiar feature is that each company has launched its cellular and WLL service in the same circle. Eventually it raises many issues like whether the companies are hedging or spurting their risk by investing into all three lines? Do we see industry following the suite and why?

Footprints

The Tata Group was one of the early birds in the telecom services. It has been gradually and quietly expanding its telecom business in the past six years. Tata ventured into fixed line and cellular service by two separate entities. One is Tata Teleservices Ltd., which provides fixed line along with WLL service, and the other is Idea Cellular were Tata holds 33% stake. Tata Teleservices provides service in Andhra Pradesh, Gujarat, Karnataka, Delhi and Tamil Nadu. On the other hand, Idea Cellular is present in Madhya Pradesh, Andhra Pradesh, Gujarat, Maharashtra, and Delhi. The investment pattern makes Tata present in all three lines.

Mobile sector is growing at a rapid rate and building customer base in current market stands to be essential for the future of every player

Reliance commenced its telecom business by providing cellular service in eastern zone, Madhya Pradesh, Himachal Pradesh, Bihar and Orissa. Though Reliance has its presence in eight states none of them are highly lucrative. In fact, after covering eight states, Reliance has built a customer base of 5,37,813 only, which is 4.57% of the existing cellular market. People living outside the state do not know about its cellular venture. Then, Reliance entered into WLL and fixed a line service through CDMA 1X technology spread across 60,000 km, covering over 600 cities and towns in India. So Reliance presence in all the three segments makes it fall into the third category.

Fascinating factors

According to the new licensing policy, a company that falls into the third category needs to pay for two licenses, which translate into huge investment. Then, what makes these companies to venture into all three modes of telephonic communication? Definitely few advantages are associated with it. Ramadesikan, Telecom policy expert from IIM, Ahmedabad, feels, "Provision of all three services will help in sharing the network used to carry trunk traffic, acquiring bulk customers by packaging services, and sharing of switching equipment. Interconnection charges may not apply if the call originates and terminates within the same provider". The presence in all lines enables companies to reduce their operational cost and makes it feasible for the other companies to follow the suite.

Mobile sector, which includes cellular and WLL users, is growing at a rapid rate and building customer base in current market stands to be essential for the future of every player. If companies don't create their presence now, then other players have an opportunity to tap the booming market. Supporting this viewpoint, Ramadesikan says "Reliance wanted to enter WLL because the mobile market was booming and its presence was very limited in the GSM mobile market. When the fixed line licensing was freed the fixed line operators convinced the government to link limited mobility to it. Therefore, fixed line licensing, which is cheaper than the cellular license, became the vehicle of entry into mobile business. So Reliance got into fixed line to enter WLL to

overcome its limited presence in the GSM mobile market." Prior to the launch of fixed line and WLL service, Reliance's presence in cellular market stood limited. Added to that Reliance did not have a presence in any of the lucrative circle in cellular service because Department of Telecommunications (DoT) permits only four licenses and all players were already present in the lucrative market. Eventually, Reliance was losing the mass market in mobile sector to its competitors.

Obtaining license in both lines may benefit companies but few factors may restrict them to follow the venturing pattern. Though companies can make use of their existing network and cut their operational cost, initially they have to pump in huge funds to secure both the licenses. Licenses include a basic telephony and cellular license. Cellular entry fee is supposed to be very high because of the bidding process for securing license. Comparatively, WLL players don't have to pay very high entry fee. For circle A, B and C they pay between Rs. 110-35 cr, Rs. 25-10 cr and Rs. 1-10 cr respectively. A critical point raised here is, will companies venturing into both fields be able to reap the amount of investment in future especially in such a highly competitive market.

The speculation about the spectrum allocation still continues. The spectrum allotted to a service provider determines the number of subscribers it can service in a circle. Earlier, when spectrum management was not an issue at all, it had been liberally allocated to departments such as Defense, Home and Railways, but now with the proliferation of new technologies being inducted into the country, the demand on spectrum by users has increased manifold. The scarcity of the frequency spectrum is a bad sign and implies that it will be difficult for new players to obtain cellular or limited mobility licenses. Sandeep Mathur, COO, Tata Teleservices, Andhra Pradesh confirms, "Since DoT has not kept restriction on the number of WLL players in a circle, it doesn't mean that every player can enter easily into WLL. Before venturing into WLL, the companies need to consider the availability of spectrum."

Cannibalization of the market share is one of the major issues when Tata and Reliance are present in the same circle with two competing product offerings viz., Cellular and WLL service. To an extent market targeted by either services overlap each other, leading to an intense competition between their own products. Cannibalizing can be looked at two angles. If the presence of both the service providers increases the overall market share of the company, then it is not an issue to be worried about. On the other, this may not seem to be an issue because the switching cost for a customer stand to be very high as the cost of handset charged by each service provider is high. Thus, a user of either service may not shift to the other service because this would require another handset.

Cannibalization of the market share is one of the major issues when Tata and Reliance are present in the same circle with two competing product offerings

Future issues

The mobile handset used by cellular and WLL user is different because both the services work on different broadband. It makes the switching cost very high for a user. Research on handsets is being carried out as to which is compatible to both the broadband i.e., cellular and WLL. If a handset is compatible to both the broadband then the switching cost of the customer would be reduced. A customer can use WLL service within the city while outside the city he can use a prepaid card of cellular service and use the same instrument. A mobile instrument with dual band would allow players to provide customers with a bundle of products and schemes. Eventually, the presence of a company in WLL and cellular will retain the client by providing them full roaming facility. Thus presence of dual band mobile would aggravate the trend of venturing into all the three modes of telephonic communication.

The whole telecom industry is working on two different technologies. An issue can propel the trend in the industry. Pointed by Sandeep Mathur "Other than consolidation the future lies with the convergence of technology where GSM player can provide WLL service by using its existing network." Bharti is already on its way to provide WLL service on its existing GSM network. The convergence would allow players to tap the booming market by using the existing network. But it is not going to be easy as this calls for a lot of policy matters.

Following the footsteps of Tata and Reliance, BSNL is coming up in a big way in WLL service after venturing into cellular service. Strategic move made by BSNL and Bharti confirms the benefits associated by falling into the third category. However, the benefits of operating in three segments do not come free of cost and it has to be seen whether companies can earn a reasonably good return on investment. Though it is not possible immediately to predict the financial viability of operating in three segments, the current scenario portrays a pleasant outcome for the consumers. As convergence of technology comes true and policy matters are sorted out then Indian telecom industry can foresee a positive trend.

Preet Jajoo

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The Dominant Dollar?

The days of dollar dominance are far from over. True, the currency has come down from its previous highs but that correction was long overdue given the lackluster performance of Wall Street as well as the fiscal policies of various nations across the world. In a unipolar world, where US is the sole superpower it is hardly surprising that dollar was the currency of the world. The US economy's robust growth during the decade of 1990s and the tremendous confidence investors across the world placed in the US economy helped the dollar raise by 50% between July 1995 and February 2002.

However, the socio-economic scenario today is very different. The burst of the Internet bubble and ensuing recession in the US economy initially brought down the value of the dollar against the euro. The war against Iraq as well as oil-related tensions have forced its downfall further. There seems to be a herd instinct acting in the market to drive the dollar downward. The present geopolitical problems, the line of corporate scandals surfacing in US have eroded the confidence of foreign investors. The economic fundamentals of the US economy add another dimension to the problems of the dollar. The ballooning trade deficit of the US is a major cause of concern. John Snow's announcement that he would reconsider the 'strong dollar' policy initiated by the Bush government further stumbled the already battering dollar. All these factors have made the US dollar look 'unattractive' to foreign investors.

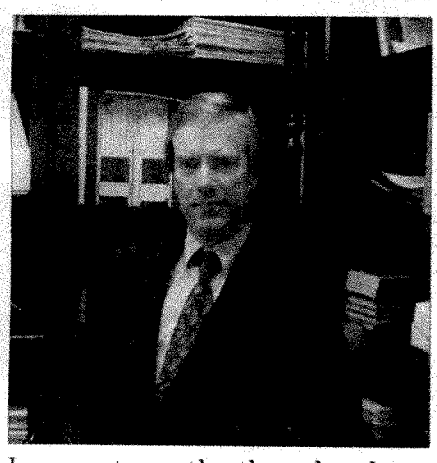
The drop in dollar could have severe implications for many countries across the world specially the export dependant economies of Asia. How significant is this fall in dollar against other currencies such as the euro? How sustainable is the rise from other currencies? What does it indicate about the global economic scenario? Is it a precursor to changing equations of economic dominance or just a necessary correction with the ranks largely remaining unchanged? Is there anything the US can do to restrict this so-called downfall or should it do anything in the first place are the questions arising in the minds of many.

In such a scenario, the future sustainability of US dollar has become a debatable issue and to discuss these and other issues like the dollar's surrender to euro, the impact of the war with Iraq on dollar and the implications of the discontinuance of the 'Strong Dollar' policy, the *Analyst* invited Wray Randall, Professor of Economics, University of Missouri, US; Dr. Michael Schubert, Senior Economist, Commerzbank, Germany and Ashraf Laidi, Chief Currency Analyst, MG Financial Group, New York, to debate these issues.

Ramakrishna Neti and D G Prasuna

Wray Randall

Professor of Economics, University of Missouri, Kansas City, US



In recent months there has been much talk about the 'weakness' of the US dollar, with some predicting a coming 'collapse'. I think this is all very much overstated. While it is true that the dollar has fallen somewhat against a number of other currencies, it has remained 'strong' vs. 'traded goods' given the deflationary trends around the globe. Hence, there is certainly no significant effect within the US of this currency depreciation. That is to say, there are no inflationary pressures resulting, nor are consumers forced to cutback their spending on imports. Further, it must be recalled that over the Clinton boom, the dollar rose significantly against most of these same currencies; hence, what we see now is mostly a reversion to pre-bubble exchange rates. I think some of this fall of the dollar might be due to lackluster performance on Wall Street. However, much of it is due to the domestic policies of other nations, which are pursuing a strong deflationary fiscal policy. In any case, it is quite incorrect to presume that the goal of economic policy ought to be directed to appreciation of the domestic currency. Certainly, Japan's yen has remained 'strong' throughout its decade-long recession, but it is difficult to see how this has benefitted the Japanese economy. A more stimulative fiscal policy aimed at raising employment would have been far better. As Euroland economic growth slips ever closer to negative territory, it is difficult to see why the strength of the euro ought to be taken as a sign of good economic performance.

It must be remembered that imports are a benefit, and exports are a cost. A trade deficit means that Americans get to consume goods and services that they did not have to produce. The trade deficit results primarily from restrictive fiscal policies in the rest of the world that keep those populations from being able to consume what they produce. Hence, the products of the rest of the world are sent to American consumers because governments all over the world refuse to let domestic demand expand sufficiently. Obviously, this is not a situation that the US can or should correct. If the US were to follow the example of Euroland and tighten the fiscal stance even as unemployment rises, this might succeed in reducing our trade deficit, but it would lower demand for the exports of other nations. This would only compound the unemployment problems of East Asia and Europe. A nearly worldwide relaxation of fiscal stances would be the best solution but this is not something the US can control.

A trade deficit means that Americans get to consume goods and services that they did not have to produce

It is far from clear that the US can or should do anything. History shows that interest rates have little impact on exchange rates—there are many examples in which nations have raised overnight interest rates to 100% and beyond without halting a depreciation. Japan has overnight rates equal to zero, without initiating depreciation of the yen. Tight fiscal policy can often place upward pressure on a currency, but with negative impacts on employment and growth. Fiscal policy in the US is still too tight even with the tax cuts and (fairly small) increase of defense spending. It would be highly counterproductive to try to increase the value of the dollar by tightening the fiscal stance. Further, as I mentioned earlier, there is no inflationary impact to date from the depreciation of the dollar because of the strong deflationary forces around the world. There are two reasons I do not expect much further depreciation of the dollar. First, given that there are only four major currencies around the world (dollar, euro, sterling, yen), the major players will not allow large relative movements of any of these. If the dollar were to fall by a third relative to the other three currencies, this would represent a huge appreciation of those currencies that would place exporters with costs in these currencies at an insurmountable competitive disadvantage (and especially with respect to producers in those nations that peg to the dollar). Hence, they will pressure their governments to respond (for example, by direct intervention into foreign exchange markets). The second reason I doubt that depreciation of the dollar will accelerate if dollar-denominated assets remain (and will remain) in demand. As the worldwide recession gathers momentum, wealth holders will seek a safe haven. The US trade deficit provides dollar income and dollar assets that will be increasingly demanded as domestic markets in Euroland and elsewhere worsen.

To date, the impact is fairly small. According to recent press reports, the US military spent about $20 bn on the war, with

expected further costs running about $2 bn per month to maintain troops in the region. The demand gap in the US is probably close to $600 bn annually. Hence, the increased defense spending is just a drop in the bucket. There was some disruption of oil markets, but to date this has not had any significant impact.

A trade deficit is mostly the result of non-resident desires to accumulate US dollar-denominated financial assets. It is this desire that drives US ability to net import. Most of the concern about the dollar results from the misconception that the US 'needs' to borrow in order to run a trade deficit. This has got the direction of causation exactly backwards. The rest of the world uses its trade surplus to obtain the financial wherewithal to take positions in dollar assets. Thus, in an important sense, we can argue that the US trade deficit 'finances' the rest of the world's net saving in dollar assets. So long as governments around the world misperceive exports as a benefit and imports as a cost, they will maintain overly tight fiscal policy in an effort to run trade surpluses. If they correctly recognized that imports are a benefit, they could relax fiscal policy, increase domestic employment, and consume their output rather than sending it to US consumers.

Dr. Michael Schubert

Senior Economist
Commerzbank Economic Research
Germany

Towards the end of last year, the dollar lost considerable ground to the euro and to other currencies. It ended the year at $1.05 to the euro, having fluctuated between July and the beginning of December within a relatively narrow band of $0.97 to $1.01. The main reason for the US currency's weakness was probably mounting fears of a military conflict in Iraq. In the event of a war

international investors would have been less willing to take risks. It would then be more difficult to attract the influx of capital needed to make up for the US current-account deficit.

The suspicion that around the turn of the year exchange rates had been increasingly affected by concerns about a war was borne out by the increasingly tenuous connection between the strength of the euro on the one hand and the price of oil and the S&P index on the other. In so-called normal times, there was a negative correlation between the price of oil and the external value of the euro: If the oil price rose, there was greater demand for the dollar, and the external value of the euro dropped. During the latter part of 2002 and at the beginning of 2003, though, both the price of oil and the euro vs. the dollar rose in the face of growing fears of a war, i.e., the correlation was positive. In addition, increasing divergence at that time between equity price movements and the dollar-euro exchange rate suggests that international political considerations were dominating the exchange rate, but were of secondary concern for the US equity index.

The exceptionally close correlation around the turn of the year between the dollar-euro exchange rate and the price of gold is also striking. To be more accurate, the coefficient of correlation of a moving correlation between the price of gold and the dollar-euro exchange rate over a period of 30 days amounted to over 0.9 from mid-November to mid-February. Since gold is a classical crisis indicator, it seems reasonable to attribute the rise in both the euro and the gold price to fears of a military conflict in Iraq.

During the period of war in Iraq, the dollar-euro exchange rate closely followed events in Iraq, and fundamental data played a negligible role. In the middle of April, the situation—at least with regard to the development of some key financial variables—can be described as follows: The correlation between US equity prices and the dollar-euro exchange rate has been similar in recent weeks to that during a large part of last year. In April, the coefficient of a moving correlation over a period of 30 days stood at over 0.8. However, a certain shift in the level has taken place: If the dollar-euro exchange rate is explained by means of a regression model with the S&P 500 index as the only influential factor, the average absolute error obtained for the period April 2001 to the end of 2002 is less than 2 US cents. It is true that since the beginning of the year the estimate thus obtained and the actual dollar-euro exchange rate have largely run parallel to one another, but the estimate is roughly 8 US cents lower than the actual figure. It is not possible to determine the cause of this shift by econometric means. These 8 US cents might be a war premium because investors are moving from dollars to euros, considering the latter more reliable. However, it is equally plausible that the dollar's weakness in recent months was triggered by the international situation, but that pessimism about the currency remains even though this factor is no longer topical. In other words, the herd may now be galloping in a different direction,

and may stick to it. In the first instance, the euro would probably lose considerable ground to the dollar once the situation in Iraq has stabilized, whereas in the second this would not be the case.

In our opinion, the above-mentioned herd instinct plays a major role in the development of exchange rates—at least during so-called normal times when exceptional factors like the war in Iraq exert no influence. More precisely, the herd instinct means that only a number of factors affecting an exchange rate are considered. Every market player, eager to maximize earnings, considers it rational to concentrate when gathering information on the aspects, which he feels, will influence other investors. If this strategy is successful, the focus on just a few variables results in a self-perpetuating process.

In fact, in addition to the present geopolitical problems, there are a number of other factors, which could lead to a pessimistic view of the dollar. It started to suffer in early 2002, as enthusiasm for the new economy faded and reports of dubious accounting practices (Enronitis) appeared at an alarming pace. There was already speculation then that the US might abandon its strong-dollar policy. In future, the dollar might be hit by fears on the financial markets of a twin deficit.

How strong are the hints that the herd has now been galloping in a different direction? For example, the forex markets' response to economic indicators published suggests that there may have been such a change of view regarding the dollar. At the end of 2001, the Bank for International Settlements (BIS) ascertained that perceptions were distorted in favor of the dollar. More exactly, it established how the dollar-euro exchange rate reacts to unexpectedly good or bad indicators from the US and the euro area. One significant finding was that as of the first half of 2000 the foreign exchange markets ignored unexpectedly sound indicators from the euro area, but not negative ones. In the meantime, the situation may have changed, at least with regard to the US indicators published. This is apparent from an evaluation of the unexpectedly good and bad US indicators since November 2002: When data have been disappointing, the dollar has predominantly weakened against the euro, but when they have been positive, there has been either no reaction at all, or only a brief one. (This pattern was not observed during the period of war in Iraq. At that time, fundamental data played a negligible role.)

An alternative method to check whether the herd has changed course is via econometric models. If there is a general change of heart, this should mean that greater attention is meanwhile being paid to fundamental factors previously given little consideration. In order to ascertain whether a change in the herd instinct had occurred, we examined whether the results obtained using models that showed close correlation with actual exchange-rate movements were now producing worse results, and vice versa. The results do tend to suggest a change of mood:

The forecast error produced by a model based on the real money market yield spread and the difference in consensus growth was closest to actual developments. More precisely, the dollar-euro exchange rate has been moving within the model's confidence range since the beginning of the year. Previously, from 1995 to 2000, it (or rather, the dollar-Ecu rate prior to 1999) was explained very well by the model's variables. During this period, the mean absolute error produced by the model amounted to only 2%. However, according to this regression approach the euro is at present still undervalued vs. the dollar by more than 5 US cents.

Bearing these considerations in mind, we think it is sensible to distinguish between three phases when predicting the dollar-euro exchange rate:

- We expect the dollar to recover in the short-term, although only on a moderate scale and for a limited time. The success of the US military campaign in Iraq and the resulting decline in uncertainty should benefit the currency, and we expect it to reach its lowest point at $1.05.
- A number of indicators reveal that the underlying pessimism about the dollar remains unbroken, even though the strains of the Iraq conflict are easing. Other negative factors are still exerting an influence or are assuming a more prominent role: The end of the new-economy boom, fears of the strong-dollar policy being abandoned, surprisingly modest US growth given the generous stimulus provided by the Fed and the administration, and speculation about a mounting twin deficit. Consequently, the euro should rise to over $1.10 over the course of the year.
- We expect the Fed to start raising interest rates again as of next spring. In other words, the strains under which the US economy is suffering will gradually start to ease, and a slightly more positive attitude towards dollar investments should emerge. This is reflected in our forecast for 2004 in our prediction of the dollar-euro exchange rate moving sideways over the coming winter, after which the dollar should strengthen a little. In a year's time, we expect a figure of $1.11 to the euro.

The widening US current-account deficit, dating back to the second half of the 1990s, is a source of constant worry among international institutions, as its sustainability could become very

problematic. If the deficit keeps mounting, US external liabilities would represent a growing share of world portfolios that at some point investors could become unwilling to hold. The ensuing large adjustment in the current account and fall in the external value of the dollar would lead to substantial distortions in the world economy and upsets in the United States and world financial markets.

Officially, the current position of the current account is not a concern for the US Government. According to US officials, such a situation is just a result of rational saving and investment decisions by private agents, who are willing to invest in America expecting higher returns.

However, the most recent developments have raised new doubts about the possibility of a return of the deficit to a less worrying level. First of all, whereas the dollar has depreciated strongly against some key currencies like the euro, the change in the real effective exchange rate is much less impressive, although it is the latter which influences the current-account position. In April 2003, the broad real effective exchange rate, as calculated by the US Central Bank, is only 3% lower than in 2001 on average.

Secondly, the reduction in economic activity coupled with the sizeable measure of fiscal stimulus enacted by the Bush administration has turned the US Government budget to deficit. Economic theory and historical evidence establish a strong linkage between government and current-account deficits, with the latter growing in line with the former. Following an expansionary fiscal shock (i.e., a combination of lower taxes and increased expenditures, such as the recent policies implemented by the US administration) national savings decrease, leading to a worsening of the current-account position.

Therefore, a main conclusion is that imbalances do matter and should prompt governments to adopt a prudent fiscal policy, aimed at reducing the deficit or creating a small surplus in the medium-term. At the same time efforts should be made to promote private savings and to restore investors' confidence, because this seems to be the only reasonable way to create the flow of foreign investment needed to finance the current account deficit.

The US Government insists that it has not changed its strong-dollar policy, but the currency's decline accelerated noticeably after the departure of former Treasury Secretary Paul O'Neill, who after a rough start two years ago became a strong defender of the dollar. Later on, comments from the newly elected US Treasury Secretary John Snow put pressure on the dollar. He was not particularly concerned, he said, about the currency's present weakness. The Treasury did then confirm that it remained committed to a strong dollar, but this came too late to banish doubts on the financial markets.

Despite such doubts, we are not convinced that rumors about the US Government trying to get rid of the strong-dollar policy will play a major role in the future development of the dollar. In our opinion, the market's doubts about the strong-dollar policy are more a consequence than a cause of the current overall pessimistic view of the US currency.

Ashraf Laidi

Chief Currency Analyst
MG Financial Group, New York

The dollar's decline is a cogent manifestation of a currency being in the wrong place at the wrong time. The downtrend began in March 2002, coinciding with the Bush administration's decision to impose a 30% tariff on US steel imports, prompting shudders amid major trading partners. Later that month, US manufacturers, feeling the bite

of the strong dollar and the emerging recession, launched a boisterous offensive against the Administration's 'strong dollar policy', on the grounds that the overvalued dollar was contributing to their deteriorating competitiveness and heightened slump. The fall of the currency gained speed as mounting revelations of corporate fraud and accounting malfeasance eroded market confidence, prompting investors to delve into the meaning of capitulation. Just as the falling dollar began to stabilize in late summer/early autumn following the Securities Exchange Commission's deadline for US executives to certify the veracity of their financial statements, the currency faced renewed damage as the US further isolated itself by launching a diplomatic, then military offensive in Iraq.

With the dollar losing 17% in trade-weighted terms since 2001, the downtrend is increasingly looking like it's here to stay. The ballooning trade deficit finally appears to encounter difficulty in garnering the necessary financing from abroad. Last year, total net foreign investment in US assets fell for the first time in four years. Net foreign flows in US stocks fell by a third in 2001, and more than halved in the following year. Net foreign purchases of US corporate bonds fell 18% in 2002, posting their first annual decline in seven years, raising the risk that US capital

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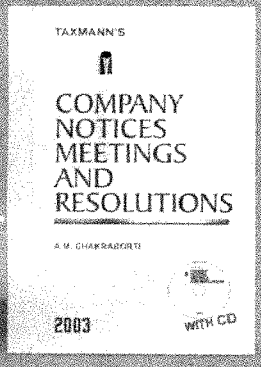

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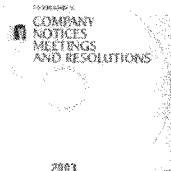

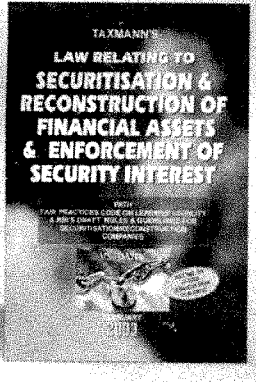

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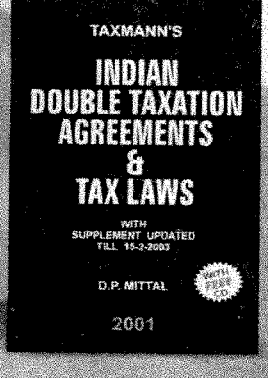

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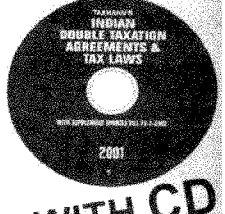

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markets will not draw sufficient capital to finance the external gap.

Indeed, the US dollar did hit 15-year highs just over two years ago, shunning the US trade gap. But that was then—when neither corporate fraud nor geopolitical risks appeared in currency desks' radar screens. Today, the dollar rests on a questionable foundation, characterized by mounting trade and budget deficits. The pervasive threat of terrorist attacks could still loom large as long as multilateralism dominates US foreign policy.

The Bush administration's rhetorical backtrack from the strong dollar policy has certainly provided markets something on which to trade. Despite the administration's occasional ceremonious reiterations citing a strong currency to be in the US interest, officials at the Treasury and the Fed have lost little sleep over the dollar's slide. The weaker dollar has even improved profit margins of a few exporters and manufacturers.

But in the interest of the global economy, it is essential for the currency of the world's economic superpower to preserve its purchasing power so that it supports the more export-dependent economies of Asia, Europe and Latin America. Foreign trade accounted for 12% of US GDP in 2001, while it accounted for 19% of GDP in the Eurozone and 28% in the UK. Europe's relatively large share of exports from Asia makes it vulnerable to catching a cold from a US-caused sneeze in the eastern continent. Since these economies are more apt to reap the benefits of currency devaluations, it is only appropriate for the US dollar to preserve its value, if not gain further. Thus, prolonged declines in the US currency risk sending severe supply shocks in Asia, Latin America, and most of all Europe—where central banks' monetary policies are relatively limited by inflation targets/ceilings.

The only remnant of the Clinton administration's strong dollar policy remaining in the current administration is ceremonious lip service rather than any cogent policy or strategy to support the currency. Such a shift has not only extended the dollar's decline, but also began to show positive results in the bottom lines of some US multinationals. The weak dollar has also contributed to the second consecutive monthly decrease in the trade deficit, bringing the imbalance to $40.23 bn in February from an all time high of $44.88 bn in December.

Uncertainty from the war in Iraq has prompted businesses to further delay spending on capital outlays, new orders and hiring. This in turn has damped already soggy consumer expenditure, driving confidence to 10-year lows. A domino effect also tends to filter back through to businesses, when consumers scale back purchases. Although oil prices remained largely stable during the war, the economy remains burdened by rising budget and current account deficits estimated as high as 5.3% and 3.5% of GDP this year. The $70 bn spent on the war and the $60-70 bn allocated for rebuilding Iraq will keep the Federal budget in the red for years to come. Not to mention projected defense spending that could have been allocated to beleaguered industries such as airlines and telecom.

Also, an oft-overlooked issue is that of escalating state deficits. California's budget shortfall stands around $35 bn while New York's is at $11.5 bn. The effectiveness in which Washington's stimulus package overcomes these local deficits remains doubtful, especially when the core of the stimulus revolves around tax cuts rather than increased spending. What stood as a $726 bn stimulus now appears to be reduced in half by Congress. And until the fiscal stimulus comes through in the second half of the year, the economy remains dependent upon the eroding armory of the Fed's monetary policy.

As US foreign policy assumes a pre-emptive posture, the US economy and the dollar will suffer the erosion of the peace dividend, which prevailed throughout the 1990s, when governments savings realized from reduced military spending were allocated to troubled sectors. No longer is the case today. Already down 15-20% against the major currencies, the dollar rests on a shaky foundation as investors seek high yield and low risk.

Amid the key distinctions between today's twin deficit environment and that of the mid-1980s is the level of interest rates. Double-digit interest rates served as a generous destination for foreign investors seeking high yield, which contributed to the soaring dollar. Today, the emerging imbalances, albeit lower than two decades ago, are accompanied by the lowest interest rates in nearly half a century. Not only global investors have a host of higher yielding alternatives such as the Australian dollar, Canadian dollar and euro, but they also can find opportunities in several currencies with far geopolitical risk than the dollar. In the risk-reward equation, the dollar appears to have lost the peace dividend and accumulated the geopolitical risk.

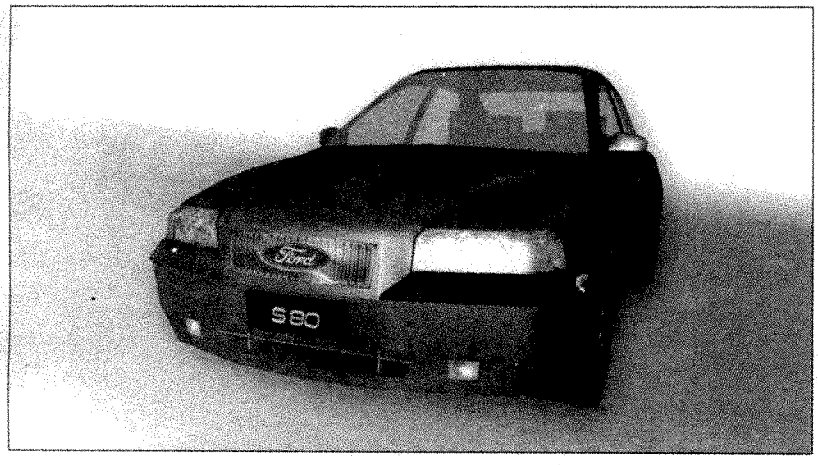
Reference # 1-2003-05-11

The views expressed are the personal views of the participants and not necessarily of the organizations they represent.

FORD

Tussles with turnaround

Having taken over the reins of Ford Motor during one of the bleakest periods of its history, Bill Ford has taken some bold initiatives to turnaround the company. Will his moves pay-off ?



On October 30, 2001, when William Clay Ford Jr. (Bill Ford) took over the reins of Ford Motor Company (Ford), from Jacques Nasser, the company was engulfed in problems on all fronts. The company that posted a net income of $7.2 bn in 1999 incurred a loss of $5.5 bn (including a one-time write-off of $4.1 bn in restructuring costs), in 2001. This apart, Ford was suffering from serious quality problems with many of its vehicles being recalled in large numbers. The Firestone fiasco further damaged the image and cost it $3.5 bn. Its share price continued its freefall and was hovering around $10 as of January 22, 2003. Bill Ford, faced with the onerous task of putting the company back on track, had initiated some concrete measures amid skepticism about his abilities to turnaround the company.

Meanwhile, troubles began to escalate at Ford. On one hand, the company's image was down with the Firestone controversy and on the other hand, the quality of Ford vehicles slid down to lowest among the Big Three [General Motors Corporation (GM), Ford and DaimlerChrysler] automotive companies.

During Nasser's tenure, the company spent in diversification schemes, including car junkyards and e-commerce ventures, which did not deliver the expected results and shrank the reserves of the company, taking the figure down to $1 bn from $15 bn. With the profits, market share and quality of vehicles going down, the Ford family that controlled 40% of Ford Motor, decided to put back the reins in the hands of a Ford family member in an attempt to regain the lost confidence and market share, and ousted Jacques Nasser, bringing Bill Ford, great-grandson of the founder Henry Ford, to the top job.

Under Jacques Nasser

Being stuck for decades as a No. 2 in the US auto industry, Ford seemed to overtake its long-time rival, GM, when Jacques Nasser (Nasser) was named Ford CEO in 1999. Nasser was a seasoned Ford executive who climbed his way to the top through various positions from 1973 when he joined Ford's North American Truck Operations to become CEO of the company in 1999. He held various positions at Ford's International Automotive Operations (IAO) including managing Asia-Pacific and Latin American operations. In 1993, he was made Chairman of the Ford Board of Europe and then the Group Vice-President for product development in 1994. In 1996, Nasser was made the head of Ford Automotive Operations. During his tenure, Nasser wanted to turn the company into an automotive consumer powerhouse providing everything from credit to automotive repair and used parts. To achieve this objective, he started taking steps to transform the company to meet the requirements of the new economy. His actions met with a lot of resistance from employees, suppliers and dealers alike but Nasser pursued with his agenda.

During late 1990s, he initiated an Internet strategy with an allocation of $1 bn to make Internet an integral part of all the activities at Ford. At North American International Auto Show in January 2000, he showcased concept vehicles that were named '24.7' and featured Telematic technology, voice activated navigation, organic LCD video displays and mobile Internet access. His dream was to put 'Internet on Wheels'. Nasser announced the launch of Ford's Wingcast telematics unit—which would allow consumers to use their cars as Net portals, ready to tap into the information superhighway from the road. Nasser also formed joint ventures with an array of high-tech

partners ranging from Qualcomm Inc. to Yahoo!, and even announced plans with Yahoo! founder Jerry Yang to give every Ford employee a computer and Internet access.

Nasser's passion with the Web during the Internet boom led to the creation of Covisint, a B2B site formed in collaboration with GM and DaimlerChrysler. Ford also moved aggressively to begin retailing its cars online, and boldly moved to sell factory-direct to consumers, by-passing dealers and their large mark-ups. Also, a controversial annual employee evaluation process that Nasser introduced, incited middle management to launch a class action suit against the company alleging it with discrimination against middle-aged white males. His efforts to change the conservative culture at Ford to the one with modern outlook with Internet-savvy employees fell flat. Nasser's efforts to bring in a drastic change appeared to have been done in a very short time. When company's problems kept mounting and the crisis deepening, the Ford board created 'Office of the Chairman and CEO' in July 2001, giving Bill Ford more operational control over the company. What began as a structure to streamline the management process and improve decision-making efficiency, did not last long and in October 2001, the board replaced Nasser with Bill Ford.

Bill Ford Takes over

When Bill Ford took over, the writing on the wall was clear: Undo the unintended troubles and bring back the company on track. Bill Ford took over the job amidst reports that he took up the job rather reluctantly. A Ford Executive commented in *Fortune* magazine, "Most guys who take this on had career-long ambitions and come to the job rubbing their hands together. But this guy came with his hands over the eyes, saying, 'Why me, why me, why, now?'" Many people felt that he was not ready for the job. Although he had worked at the company for 16 years—and held 15 different jobs—he had never run an operation larger than a tiny Swiss unit. Now, Ford, 45, carries the full burden of the expectations of the company's employees, dealers, suppliers, and investors—including his extended family, which still controls 40% of Ford Motor.

As soon as Bill Ford stepped into the shoes of Jacques Nasser, he laid a plan to restructure the entire organization (see box 'Bill Ford's Plan of Action) that included plans to eliminate 35,000 jobs, close five plants and do away with four models. Bill Ford gave himself a time period of five years to achieve the turnaround. He set himself the target of reducing the costs by $4.5 bn and improving profits by $9 bn by mid-decade. He expected to put the company back on growth track by replacing aging mass-volume cars such as Taurus with vehicles geared to more specific consumer tastes. Ford had few promising vehicles in the making: The overhauled F-150 pick-up—Ford's top-selling vehicle and two pivotal vehicles: The Ford Five Hundred big sedan and CrossTrainer, a car-SUV hybrid, both of which Ford planned to launch in 2004.

In March 1999, Nasser created Premier Automotive Group (PAG) and moved Ford's luxury brands to it. The strategy was seen as the perfect way to prevent the luxury marques such as Jaguar, Land Rover and Aston Martin from being diluted by Ford's more mainstream brands. In his urge to expand the product profile, Nasser spent billions of dollars to acquire brands such as Volvo (aimed at strengthening Ford's presence in European-style luxury cars) and Land Rover, a manufacturer of sports utility vehicles and bought businesses ranging from repairs to recycling.

Bill Ford also saw it as a potential source of generating revenue and playing an important role in the revival of fortunes of the company. He expected PAG to deliver one-third of corporate profits by 2005. But this was considered to be of tall order. The PAG generated bulk of its revenues from Lincoln but the overall sales of the vehicle were down in 2001. Questions were being raised about the efficacy of the group. Ford purchased Volvo and added it to the PAG range at a steep price of $6.45 bn. The fact that the production for Volvo remained at Sweden where production prices were high, and to get any return on the purchase of Volvo, Ford had to sell more vehicles.

Troubles – Far from over

Despite all his efforts, troubles seemed to be far from over for Bill Ford with problems arising out of unexpected corners. Bill Ford enjoyed a rare rapport with union leaders. He was a member of Ford's bargaining team when it was formed in 1982. But his plans to shut plants as a part of the restructuring exercise hurt the relation. Life seemed to be easy for Bill Ford when he was corporate director or the non-executive chairman. At that time, he not only pledged support to the environmentalists but also pushed for the cause in his company. But he was facing the same environmentalists' criticism for opposing tougher corporate average fuel-economy standards in the Congress and for failing to improve its vehicles' fuel economy in 2002. Explaining his stance Bill Ford told *BusinessWeek*, "My commitment is no less. But if we don't get our business right, it won't matter what kind of social commitments we have."

While Ford had to focus on resolving internal problems that crippled the company, the pressure from the competitors waging price wars was mounting on it. GM, with its manufacturing efficiency, was able to undercut Ford's prices. Foreign carmakers especially that

Bill Ford's Plan of Action

- **New products:** A product-led revitalization program which will lead to the introduction of 20 new or freshened products in the US annually between now and mid-decade.
- **Plant capacity:** Reduction of North American plant manufacturing operating capacity by about one million units by mid-decade to realign capacity with market conditions.
- **Hourly workforce:** About 12,000 hourly employees in North America are affected by the actions completed in December or to be taken throughout 2002 and beyond. An additional 3,000 hourly employees were affected in 2001. Plans are being made to reassign as many plant employees as possible.
- **Salaried workforce:** Last year's voluntary separation program for salaried employees and other related actions resulted in a 3,500-person workforce reduction in North America. This program will be extended to achieve an additional 1,500-person salaried workforce reduction to reach the goal of 5,000. If necessary to meet this goal, an involuntary separation program will be used.
- **Global workforce:** About 35,000 employees will be or already have been affected by combined actions around the world since January 2001. These include 21,500 in North America—15,000 hourly, 5,000 salaried and 1,500 agency employees—and 13,500 in the rest of the world.
- **Material costs:** A material cost-reduction program has been initiated with North American suppliers which shares design savings, with Ford receiving 65% of implemented cost reductions and suppliers receiving 35% in the first year. Designs will be developed that will help improve Ford's products and overall quality. This program, along with other material cost reduction efforts, is expected to improve ongoing annual profits before taxes by $3 bn by mid-decade.
- **Discontinued low-margin models:** The Mercury Cougar, Mercury Villager, Lincoln Continental and Ford Escort will be discontinued this year.
- **Beyond North America:** Revitalization plans beyond North American automotive operations include the continued implementation of the European Transformation Strategy, the Premier Automotive Group strategy, the turnaround in South America and a revised direction for Ford Financial.
- **Divestitures:** Ford is pursuing the sale of non-core assets and businesses. Ford's plans include $1 bn of cash realization from these actions in 2002.
- **Dividend:** The annual common stock and Class B stock dividend will be reduced from 60 cents a share to 40 cents.

Source: Ford Motor Company, January 11, 2002, http://ford.media.com

of Japan and Europe and South Korea increased their strength in the US market, taking their market share to 54% in 2002 from 42% in 1998.

To set things right, Bill Ford required to overhaul his management team that underwent many changes during Nasser's time. He brought back Allan Gilmour from retirement for a second stint as CFO. Gilmour had spent 34 years at Ford and enjoyed high credibility at Wall Street. Ford signed on Carl Reichardt, former head of Wells Fargo Bank, as Vice-Chairman expecting him to bring to the table, the much needed financial acumen for the company. However, Ford missed the product development expertise of Wolfgang Reitzle who left Ford in April 2002. Reitzle, an ex-BMW engineer who headed the luxury-car group PAG, was considered Ford's most talented product manager with a deep understanding of all aspects of design from the styling studio to the factory floor. Bill Ford felt that Reitzle was pushing for more power and wanted to be a CEO.

Amidst all the problems, Ford had good news to report. Though it had a net loss of $326 mn for the third quarter, it made an operating profit of $220 mn. Also, the quality improved and recalls went down. Cost per vehicle was brought down by $240 and overhead burden was reduced by $2 bn. All this meant that there was a significant progress toward turnaround. But Wall Street did not seem to be satisfied. The share price remained to be low. An industry analyst commented in *Fortune* magazine, "It's not good enough to say, 'We are going to get better'. He needs to say, 'Here's how much we will increase our pre-tax margin. Here's how we will combat the competitive problem in 2003. Here's what we'll do if the market drops to 15 million cars (from 17 million). Here's how we keep our product development program going if our cash position suddenly worsens.'" There were also worries about the huge debt burden to the tune of $162 bn and the $6.5 bn shortfall in pension funds.

Nearly a century after Henry Ford started Ford Motor Company, the Ford family was counting on one of its members to steer the ship to safe shores. Bill Ford, with all his acumen, had tried to repair the damage by taking some concrete steps that seem to be showing results albeit slowly. Bill Ford who knows that not only his personal reputation is at stake but also the future of the company, understands that failure is not an option for him.

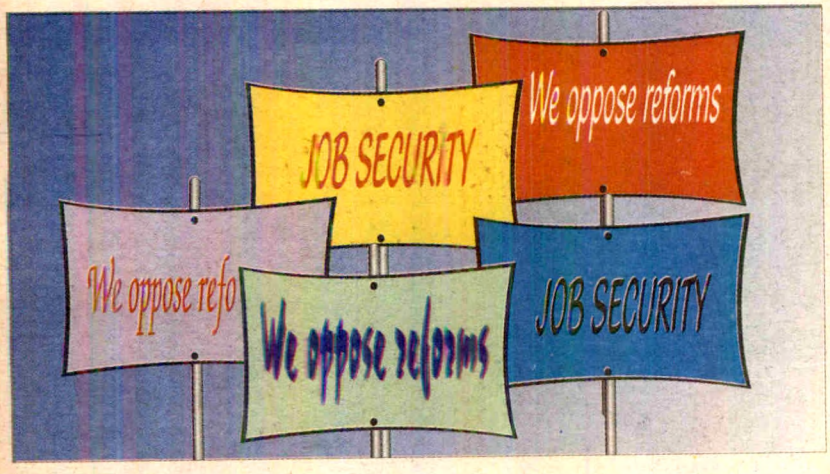
Phani Madhav

Reference # 1-2003-05-12

GERMANY's ECONOMIC WOES

Need for tough reform

German economy is mired in problems. Germany's labor laws that played an instrumental role in the post-war economic success are now stifling the growth of the country's economy.



As there is no hope for a near-term domestic recovery due to this year's hikes in taxes... and the fact that eurozone interest rates are too high for Germany, we continue to see risks of recession in early 2000.

—Holger Fahrinkrug, an economist at UBS Warburg as quoted in BBC

Long regarded as the engine of growth for European industry, Germany is slipping into recession. In 2002, German economy showed up one of the worst performances since 1990s. The Gross Domestic Product (GDP) increased by paltry 0.2% and the forecasts for 2003 were also grim. The high wages, rigid labor laws and rampant red tape combined with the proposed new taxes by the government prompted the exodus of many German companies to other low-cost locations. That in turn aggravated the already high level of unemployment at 9.7% of the workforce.

The ruling coalition of Social Democrats led by Chancellor Gerhard Schröder (Schröder) and the Greens is not able to push through with much needed economic and labor reforms. Schröder seems to be more adept at pleasing the strong labor unions than fixing the plethora of problems facing the German businesses. Agrees Simeon Mitropolitski, Reviewer, *International Real Estate Digest*, "the lack of will from the German Government to make structural reforms will go against the interests of the left electorate, which has brought twice this coalition to power. Germany lacks the economic dynamics due to highly bureaucratized social structures."

The level of unemployment at 9.7% of the workforce coupled with liberal benefits for the unemployed is increasing the burden on the state finances, putting pressure on the budget and in turn is aggravating the country's economic problems. Dirk Schumacher, German economist at Goldman Sachs in Frankfurt told *Time* magazine, "Germany seems to be caught up in a vicious circle of low employment, which leads to higher claims on the welfare state, which raises wage costs, which leads to higher unemployment."

The roots of some of the problems that the country is facing today can be traced back to the German unification period. After 45 years of separation, the Federal Republic of Germany (West Germany) and the German Democratic Republic (East Germany) were unified in 1990. The fast pace of unification came as a surprise to all concerned. In the unification of Germany, not only the political factors, but also the economic relations between West Germany and East Germany played an important role. In the years that followed, West German political, economic and social institutions were transferred to the former German Democratic Republic. After unification, the then German chancellor Helmut Kohl seemed to be more focused on the political unification. He did not pay any heed to the warnings by economists and went ahead with swapping East German Marks for Deutsche Marks at five times the value of Ostmark's real value. Also, considerable amount of money and expert knowledge were transferred with the aim of bringing East Germany on par with the development of West Germany. To compensate for the extra burden, the government levied huge taxes on the workers in the West.

More than a decade after the German unification, economic policies are showing mixed results. East Germany showed an impressive performance with most economic indicators showing a growing convergence with the

West. But this came with a cost attached to it not only in terms of increasing debt levels and huge transfers but also in terms of the inflexibility of the economy and unemployment that reached very high level of 20% in East Germany. The unemployment along with a lack of demand in the East, costed the German Government $700 bn. But East Germany remains far behind the West in terms of productivity that is 30% lower, and unit labor costs that is 10% higher. This convergence is taking much longer than the Germans thought it would in the earlier days of unification. Helmut Kohl who was the chancellor during the unification remained in power till 1998. In 1998 Schröder and the SPD formed the government in coalition with the Greens. In his first term of office, Schröder started some reforms in several important areas: Taxation, labor-market law and pensions. But as elections approached, he slowed down the reform process.

Table 1: Annual Increases in Collectively Agreed Pay 1999-2001*

(in %)

Sector	2001**	2000	1999
Banking, insurance	3.2	2.0	3.1
Commerce	2.8	3.0	3.2
Food industry	2.7	2.8	2.7
Consumption goods industry	2.3	2.5	2.6
Private services	2.2	2.3	2.1
All sectors	2.1	2.4	3.0
Trade and transport	2.0	2.3	3.0
Investment goods industry	1.9	2.6	3.6
Raw material and production industries	1.9	2.5	2.4
Horticulture, agriculture, forestry	1.8	2.3	2.3
Public services	1.8	1.9	3.2
Construction	1.6	1.6	2.0
Energy, water, mining	1.1	1.9	1.9

* Increases against the previous year;

** Figures are calculated on the basis of collective agreements in the first half of 2001.

Source: WSI Collective Agreement Archive 2001

Schröder was elected for the second term when the coalition won the general election in September 2002 with a narrow majority. In his second term the onus on Schröder was to fix the problems (many of them due to the inflexible labor laws and strong labor unions) facing German businesses and bring back the economy on track. This was considered to be a huge task since the labor unions were considerably strong claiming allegiance of three-quarters of the Social Democrats in the Parliament.

East Germany remains far behind the West in terms of productivity that is 30% lower, and unit labor costs that is 10% higher

Labor laws: The genesis

In reaction to Hitler's atrocities on organized labor, German employment began to be jointly managed by employers and unions. This resulted in the emergence of strong trade unions and a collective bargaining system, which in turn made it necessary for companies to involve in a nationwide bargaining with one of the giant trade unions rather than at the company level (refer Table 1). Also, the Kundigungsschut, the country's job protection law that saw hardly any changes since it came into being during 1950s required employers to pay huge amounts to lay-off workers and thereby discouraged them from hiring. The labor laws that were enacted after World War-II were to create a unified labor force that would reconstruct the economy. In the post-war economic success that Germany experienced, the trade unions played a major role, making them all the more powerful. But with the passage of time the labor laws not only became archaic, but also threatened the very existence of the businesses for which German labor worked.

Vanishing businesses

Schröder is evading the labor problems succumbing to the obvious political compulsions. Moreover, the high levels of unemployment and resulting burden on the state economy held Schröder back from reducing the taxes as promised by him before the election. Schröder proposed to raise taxes by •26 bn in 2003. These taxes combined with the labor problems are making it increasingly difficult for companies, especially the smaller ones to operate in the country. Even big businesses began criticizing Schröder for his proposed new taxes. Ludwig Georg Braun, president of the Association of Chambers of Commerce and Industry once told *Time* magazine, "Emergency repairs are not enough to get the economy working again. The government must show willingness for comprehensive reforms that break social democratic taboos."

Burdened by the high wages that large companies set under the collective bargaining agreements and the payroll taxes to fund the country's more than generous social welfare benefits, Germany's Mittlestand businesses, the small and medium-sized businesses that have been the backbone of the German economy for decades were withdrawing their stakes.

According to the research conducted by an association of entrepreneurs in November 2002, 7.4% of the 300 companies in Germany surveyed decided to set up their production facilities abroad, while another 32% are exploring the opportunities to shift their operations. In 2001, while German companies invested $43.3 bn abroad, foreign companies invested $31.8 bn in Germany, leading to a feeling that the country is losing its competitiveness.

The Mittlestand businesses are being forced to be content with the agreements that are made with the trade unions at the national level bargaining. Typically, those agreements favored employees than employers, providing more scope for them to escape work. For example, it was found that many employees took advantage of the laws (that provided full pay for six weeks when workers fell sick) and deliberately stayed away from work. Another problem for these companies is that employees can move from full-time to part-time employment, whether it suits the employer or not. This discouraged firms from hiring young women who usually demanded time-off to look after their children.

Even those Germans who prefer to be self-employed to avoid paying salaried workers' full social-security contributions are also facing some problems. For example, lorry drivers who work on contract for a single company are to be considered as part of the firm. As a result of this, companies began hiring freelance Polish truckers to distribute goods at a cheaper rate thereby eliminating jobs for their German counterparts. These kinds of restrictions are also responsible for stifling entrepreneurship. Berthold Leibinger, the founder of Trumpf, a classic Mittlestand firm-based in Stuttgart, commented in *The Economist*, "The Social Democrats don't understand the role and importance of the Mittlestand. They're not pragmatic. We've become a safety-crazy nation. We need to be more risk-minded. It's unbelievable that in two generations we've moved from a country that wanted to cover the world (in business) to one that is afraid of itself."

Though the German labor laws are being criticized for their inflexibility, some of the big companies have been able to find ways to adjust their workforces according to their requirements. For example, to tide over the slowdown, the German unit of Hewlett-Packard put a proposal in front of the labor unions: It asked its 5,700 workers to accept a voluntary 10% pay-cut for four months or give up eight vacation days. In order to avoid lay-offs, German managers agreed for a 15% cut from their pay to cooperate with the company. Later, 80% of the workforce agreed. Another example is the case of BMW that is yet to decide whether to build a new plant in Leipzig or in one of the low-wage locations in Central Europe. To keep the plant in Germany, the company workers agreed to put in more time in tune with the demand.

But this kind of flexibility on the part of labor unions is considered to be more of an exception. There is still a lot to be done with government rules making lay-offs a time-consuming and costly affair, leading to increased reluctance of companies to hire people. Some unions want the government to force companies to hire new workers rather than use overtime. Such demands typically resulted in increased costs and are forcing companies to relocate their production to places such as Poland, where hiring and firing are easier.

Restarting the German engine

Before Germany went into elections in September 2002, the opinion polls indicated that voters were deserting the ruling SPD. At that time, the high levels of unemployment that Schröder's government failed to control during its first term at the office was turning out to be a major issue, with the opposition CDU projecting it as an example of failure of Schröder's policies. While Schröder tried to defend himself by attributing the high level of unemployment to worldwide economic downturn, he also began looking for a way out of the problem. His much-publicized 'alliance for jobs', a joint commission comprising the government, employer and employee representatives could not provide any solution to the country's labor market problems. In what was considered to be a last ditch effort, in March 2002, Schröder constituted a committee headed by Peter Hartz (Hartz), the Chief Personnel Officer at Volkswagen with an agenda to reform the institutions and policies governing the German labor markets. The commission composed of 15 experts—two academics and 13 members drawn from trade unions, management consultancies, company managing boards and political and economic circles. As personnel director at Volkswagen, Hartz was immensely successful in negotiating crucial and innovative employment and wage deals with the powerful IG Metall and Volkswagen works council. His ability to deal with the unions came handy in running the committee smoothly. By putting Hartz in the driver's seat, Schröder successfully used the tripartite structure and at the same time avoided the bureaucratic hurdles that stifled the progress of the 'alliance for jobs'.

On August 16, 2002, the commission issued its report and Hartz announced that the objective of the proposal was to reduce the level of unemployment to half its existing levels in a period of three years. One of the main proposals of the commission was to break the Federal Employment Service into small temporary employment agencies called Personal Service Agents (PSA). For anyone who

remains without job for a period of six months, PSAs would look for suitable employment on short-term benefits and those who refuse the offer are stripped off their unemployment benefits. Another related proposal is the merger of labor and welfare offices. The formation of PSAs is considered to be instrumental in bringing down the average length of unemployment from the level of 33 weeks to 22 weeks by 2005.

To limit spending on social security, the commission proposed that workers have to inform their employment office as soon as they receive notice of termination of employment without waiting until they lose their job. It also requires unemployed people to be willing to accept a lower wage than what they got before, failing which their benefits would be cut down. The same is the case with single unemployed people who refused to relocate when a job was being offered.

Many people in Germany worked on the basis of undeclared wages. This helped them to claim the unemployment benefits that accounted for a huge amount costing the state in the form of lost revenues as well as payment of benefits. The turnover of millions of people who worked illegally was to the tune of €300 bn a year accounting to nearly 15% of Germany's GDP. To overcome this problem the commission proposed the formation of one-person companies that allowed individuals to take up odd jobs such as gardening housework etc. Those who set up such companies are allowed to earn €25,000 and were taxed at 10% compared to the normal rate of 22%.

The commission also proposed a formation of €10 bn a year towards the 'Job-Floater' program that provided loans and tax credits to businesses that created jobs in economically weak regions, especially in East Germany.

Though there was some progress on the reforms front, many of Schröder's moves left a lot undone. Many of the Hartz's proposals that Schröder promised to implement during elections were ignored after elections bowing to the pressure from unions. In 2003 State Elections, Schröder's SPD had to face the wrath of German people who voted them out of power in two states Lower Saxony and Hesse. This forced Schröder to garner support of the conservative opposition, whose strength in the upper house of the Parliament increased substantially. It is believed that the resulting cooperation between the two major parties would provide the necessary impetus to the labor reforms that is highly required by Germany.

Schröder was not able to do much in his first term. In his second term, he was expected to push through the reform process. Adrian Ottnad, Senior Economist at Bonn Institute for Economic and Social Research says, "In the past there have been strong objections against fundamental reforms. Especially the labor unions successfully prevented the social-democratic led government from necessary cuts within the social security system and from labor market deregulation. Meanwhile economic, budgetary, and unemployment problems have escalated. The red-green coalition lost a couple of regional and local elections. The German Government is now under heavy pressure. On the other hand, the opposing Christ-democrats and liberals, who hold the majority in the second chamber of Parliament (Bundesrat) want and have to prove their ability to solve the problems. Therefore in 2003 a window of opportunity for reforms might open." Barely two months after he was re-elected, Schröder's policies made him one of the most unpopular leaders of the post-war period. To bring things back on track, Schröder formed Super Ministry by combining labor and economics ministries and brought Prime Minister of North-Rhine-West-phalia, Wolfgang Clement (Clement) to the post. Clement succeeded in passing two big bills related to labor market reforms in the Parliament. These bills were based on the recommendations of Hartz commission. Clement is also working on changing a number of other deep-rooted practices including easing strict job-protection laws, reducing long-term unemployment benefits and also stopping welfare benefits for people under 25 who were willing to take a job or training. However, Clement's moves are being considered to be tepid compared to international standards and are being criticized by some as half-hearted efforts. Businessmen are feeling that there is not much reduction in the red tape.

The time is now ripe for unions and employer associations, which have strong vested interests in maintaining the status quo to realize that if they do not cooperate to fine-tune Germany's declining economy, they risk making themselves irrelevant. For Schröder, going ahead with reforms is an important business issue and yet a politically sensitive one. If the reforms are pushed through, it would instigate a strong resentment among the unions and if they are not, it would alienate the businesses of Germany. But Germans are known to change slowly. The compromise and consensus have served them well to come out of the debacles of the two wars and they usually take a long time to make tough decisions. But the question remains whether the situation has become so dire that the old tradition of compromise and consensus is no more relevant. The need for Germany, it appears, is a strong leader, someone like Margaret Thatcher, Britain's Prime Minister of the 1980s who broke the British trade union dominated mold to put British businesses on track.

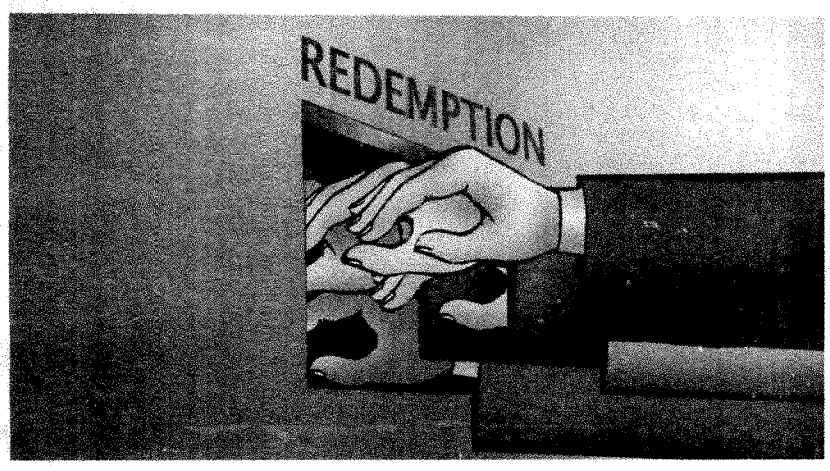
Phani Madhav

Reference # 1-2003-05-13

US MUTUAL FUNDS

Drowned in redemptions

The patience of American retail investors, who were stuck with equities through 2000 and 2001, finally shattered last year. They redeemed a net $27.1 bn from equity mutual funds in 2002.



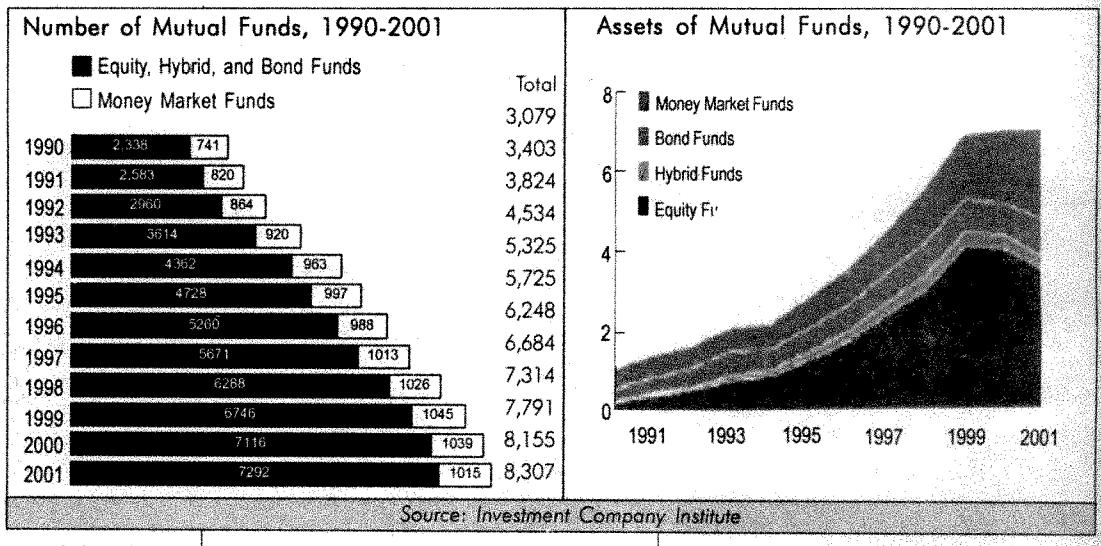
Internationally, mutual funds are the key contributors to globalization of financial markets and one of the main sources of capital flows into emerging economies. Since the mid-1980s, mutual funds have experienced the highest augmentation rate of all major financial intermediaries in the US. Part of the mutual fund industry's past success has been its ability to present investors with many straightforward benefits of having their money managed on a pooled basis by fund managers. These benefits included diversification, professional management, economies of scale, low initial minimum investments and the 'redeemability' of fund shares. Though mutual funds existed in the US since 1924, until the mid-1980s the funds flow was not significant. A decline in deposit rates in the early 1990s marked the beginning of explosive growth in the funds. As a result, mutual funds as a group have become important financial intermediaries and repositories of household wealth. The US mutual fund industry has become a giant, from its 1949 base of $2 bn, fund assets soared to $6.5 tn at the outset of 2003, a compounded growth rate of 16%. So has the number of funds multiplied, from 137 mutual funds to 8,300. Mutual funds have been Americans' favorite investment vehicle, and mutual fund companies did very well out of the boom.

Redemptions pressure

The year 2003 began with great uncertainty—there was apprehension over the impact of war with Iraq and heightened fears sparked by renewed terrorist threats. Of course, there are many dark clouds hanging over the US economy right now. There is uncertainty due to the prolonged Iraq situation that is affecting corporate expenditures and lowering consumer expectations. Prolonged war, however, can have a negative impact by means of erosion of consumer and business spending, increased inflation and government deficits, and a decline in economic output. Starting from weakening of the dollar, to increasing number of bankruptcy cases and corporate governance concerns, investors are finally restoring redemptions. The change in the industry's character has radically affected the behavior of the mutual fund retail investors.

Commenting on the reasons for the sudden spurt in redemptions, Richard D Hastings, Economist and Credit Analyst and Economics Columnist for *Credit and Collections Risk* magazine says, "In earlier years, mutual funds were sold without sufficient consumer scrutiny. Today, however, consumers have access to mutual fund details and this has resulted in an increase in skepticism about fund value and future performance. There will be periodic bursts of market optimism against a longer-term decline in liquidity. The bond markets in the US continue to pull currency out of short-term activities into long-term periodic payments, and the money supplies show an alarming increase in the degree of volatility. For this reason, mutual fund redemptions are likely to continue because there are insufficient sources of liquidity, and mutual fund redemptions provide cash assets to convert into alternative investments."

As the fund managers are introducing more and more performance-oriented, often speculative, and concentrated funds that behave increasingly like individual stocks, it attracts more and more investors for whom the long-term do not seem to be relevant. Up, up, up went the redemption rate. Last year it reached 45% of the assets, an average holding period of slightly more than two years. The time horizon for the typical fund investor had tumbled by 90%. First the cash flow stopped, and then it turned negative—$18 bn outflow in the year just ended. Today, it is not



irrational exuberance but rational disenchantment that permeates the community of fund owners, many of whom, are unaware that the great party is over and that a hangover lies ahead. John finger, author of *Your Fortune in the Financial Market* comments, "I agree the current trend is 'rational disenchantment' for those who have been smart enough to withdraw their money from stock mutual funds already. Most investors, however, are in another category, having been brainwashed by the 'buy and hold' theory. This category falls under 'irrational complacency'". Hastings feels, "Rational disenchantment is a reasonable description for the current situation. The fact is obvious upon sufficient investigation that sources of liquidity are poor in quality, and yields in the industrialized nations are too low to provide a platform for a new business cycle. The current cycle remains firmly in place. Investors are responding to measurable monetary and yield conditions." The current state of affairs is coming at a time when many investors are feeling particularly vulnerable.

A three-year market decline coupled with a weak economy and a spate of corporate scandals has shaken investor confidence. In July 2002 mutual fund investors apparently hit their psychological limit on losses and withdrew a record $49 bn from mutual funds—significantly higher than the $30 bn they had pulled out after September 11, 2001. The July withdrawals followed $18 bn in June 2002. In August 2002 withdrawals slowed to $9 bn, but most financial experts say this level still was too high to support a sustained recovery. Through the long bull market, individuals learned that the most effective way to make money was to buy more stocks. Until the final manic phase when day trading took off, their favored way of doing so was through mutual funds. The process was often perceived to be a virtuous circle, with new money boosting share prices, which brought in fresh money which further boosted share prices, and so on. There is a pervasive fear that the opposite could be unfolding now: A downward spiral, with decline in share prices prompting waves of redemptions and further price declines.

As the bear market began in March 2000, the first to leave, often not by choice, were the last to arrive. Heavily margined day-traders were quickly wiped out; unleveraged day-traders had only a bit more time to discover how little gratification there is in losing money. Brokerage firms catering to this crowd disappeared. Fund investors were noticeably more patient, contributing more money every month in 2000 and, overall, in 2001 as well. Finally, more than two years after the Nasdaq peaked, their patience is wearing thin. US investors faced the harshest financial environment in 2002 that most had ever experienced.

The US stock market, weighed down by revelations of corporate accounting scandals and downward revisions to profit forecasts, slipped for a third year in a row, posting its steepest three-year decline since the Great Depression. Furthermore, sluggish economic activity and an accommodative monetary policy from the Federal Reserve contributed to interest rates falling to their lowest levels in more than 40 years. Low interest rates and the bear market left many investors with investment returns that were below the modest pace of inflation that prevailed during the year. Even so, equity fund shareholders' response to the unusual financial conditions and slow economic growth was measured in line with the well established pattern of weak net new cash flow during periods of low stock market returns. Equity fund investors sold a small percentage of their equity fund holdings amidst the stock market sell-off. The outflow generally confirmed to investor behavior during the brief market downturns that occurred during the bear markets of the 1970s and 1980s.

Like equity fund shareholders, investors in bond and money market funds reacted to fund returns in 2002 much as they had in the past. Bond funds received a record net inflow of new cash from shareholders as the drop in interest rates boosted bond prices and lifted

Can Investor Confidence be Regained?

Sometimes the news just takes your breath away. The latest spate of accounting fraud rocking the US market is a case in hand. The number of fraud cases investigated by the Securities and Exchange Commission jumped 41% in the last three years, resulting in tens of millions of dollars in fines to settle the charges.

Given this information, it is not surprising to see the ongoing redemption trend by the US retail fund investors. Investors are rationale and adjust their investment decision based on market information. While a positive information (like an income tax cut in the forthcoming budget) can spur up consumption and investment demand, a negative information (like war with Iraq, or for that matter the accounting fraud) can do just the opposite.

Actually, most of us behave according to the popular saying, "fool me once, shame on you, fool me twice, shame on me". No body wants to be fooled over and over again. Hence, while forming expectation about any future event, an individual uses both past sets of information (adaptive expectation) and present sets of information (rational expectation), at his disposal. Based on the acquired information he suddenly becomes optimistic or pessimistic about his future, leading to a change in effective demand.

Effective demand implies what the consumer intends to buy. A fall in effective demand will lead to a fall in demand, contributing to an economic downturn. For instance, any consumer feeling less secure about the future return on his stock holdings might want to sell them. And when many such decisions coincide, it is the case of bear ruling the market. Ergo, a greater portion of this change in behavioral pattern can be explained in the way by which any individual perceives any given flow of information. Accordingly, the present case is not the case of "irrational exuberance but rational disenchantment", leading to investors' withdrawal of capital.

So what needs to be done to bring back the consumer confidence? One obvious answer is to bring back transparency in the system. The US Government, on its part, tried to bolster consumer confidence by enacting the Sarbanes-Oxley Act, which became law in August 2002. It aims to hold companies to higher standards of disclosure and corporate governance. Some changes were made to the existing law and it mainly looked at the following aspects:

Executive loans: Outlaws most corporate personal loans to directors or executives.

Making corporate officers more accountable: Chief Executives and Chief Financial Officers required to sign statements attesting to the accuracy of their firm's financial statements.

bond fund returns for the third consecutive year. This correlation between bond fund returns and flows extends back to the 1970s when these funds first began to grow in popularity. In the case of money market funds, the yield advantage of these funds over bank deposits narrowed, as is typically the case when interest rates decline. As a result, households shifted some of their short-term investments away from money market funds to bank deposits. The severity of the bear market in stocks depressed equity fund assets, which declined to $2.667 tn from $3.418 tn in 2001. By the end of 2002, equity fund assets were down 42% from their peak in 2000, mirroring the overall equity market decline. Despite stock market falls in 2000 and 2001, it was only last year that Americans made net withdrawals from equity funds. This has hurt some fund companies more than others. Fidelity, America's biggest mutual fund company, saw $3.6 bn in net redemptions from its American stock funds last year. However, with its huge range of products, Fidelity was able to offset the withdrawals by marketing bond funds and international equity funds to unaffected investors. Vanguard, which is number two to Fidelity, has pursued a similar strategy, aggressively promoting bond funds in particular. It enjoyed $38 bn in total net inflows last year. However, smaller companies have fared less. Amvescap, which owns AIM and Invesco, suffered 8% net withdrawals from its American mutual funds, which account for two-thirds of its profits. Investors withdrew a net $16 bn from stock and bond funds at Putnam, the largest outflows from any group in America. The issue troubling investors more than any other is the quality of financial information that are provided by companies. This is largely due to failures of accounting and corporate governance that are not, at first glance, really Wall Street's fault.

Is Sarbanes-Oxley Act a remedy?

The mutual fund industry endorsed the Sarbanes-Oxley Act because of the pressing need to bolster the independence of the accounting standard-setting process, strengthen the oversight of public auditing, and increase the authority and resources of the Securities and Exchange Commission (SEC). However, Harvey Pitt, the outgoing Chairman of the SEC, is determined to put in place new rules for mutual funds before he leaves. He wants to prevent the sort of scandals that have afflicted Enron, WorldCom and the big banks on the Wall Street. It will be a year or so before the effects of all changes recommended are fully felt. Commenting on the question whether the Act can restore retail investor confidence,

Executive stock sales: Executive Officers and Directors cannot trade company stock during pension-fund blackout periods when employees are prevented from trading.

However, reforms must go beyond the Sarbanes-Oxley Act. An important problem lies in the way the firms are audited. Auditors have powerful incentives to please their clients; that is to come up with a report that supports the claims of a company's management. Companies hire and fire the auditors, whose services they use. In addition, accounting firms often sell consulting and financial services to the companies they audit. They know they are unlikely to retain or obtain the business of a firm whose books they have found wanting.

So a better way would be to hire auditors for a fixed term, with no chance of being laid-off during their term of service or being rehired at the end. The government by trying to bring more transparency in the system is trying to bolster the sagging moral of the investors. But what can the fund managers do to rejuvenate the mutual fund industry.

Theoretically, the fund managers have couple of strategies to choose upon, so to make the stock returns look lucrative.

First, studies have confirmed that there is an inverse relationship between firm size and risk adjusted returns on their stocks. This is mainly attributed to the so-called small size effect. So as a fund manager, the bet would be to invest in stocks of small firms.

Second, avoid investing in aggressive stocks. Price of aggressive stocks rise more than average during boom and likewise, fall more than average at time of recession. This is basically the result of Capital Asset Pricing Model. Fund managers can minimize their risk by choosing portfolio where the variances of assets return are minimal, i.e., by investing in regressive shares.

Third, do not put all your eggs in the same basket. In this regard geographical diversification of portfolio can be helpful in reducing variability of assets return.

Fourth, with the ongoing redemption trend, it makes sense, to lower cost of investment in mutual fund. In recent years, the mutual fund industry has undergone dramatic changes to the types of fees and the expenses they charge to investors, and it is on the rise. Fund expenses include administrative, accounting, shareholder service, and advisor fees. Higher fund expenses, by affecting profitability of any investor, can affect his investment decision.

Fifth, there is a need to cap the turnover ratio. It represents the frequency at which fund managers buy and sell securities. Presently, the turnover ratio is quite high, giving an evidence of hasty decision by fund managers, which at times can be costly.

Hope these measures will take care of some of the present problems.

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Hastings opines, "Sarbanes-Oxley will provide some pressure upon corporations to improve financial reporting quality. It is not exclusively capable of fixing retail investors' poor outlook. That will require better yields on safe haven investments rather than threats of SEC investigations if a company's reports are not reliable."

John Finger feels that "We have already seen the answer to the Sarbanes-Oxley Act. Smart investors are voting with their 'sell' orders. Many are slowly losing trust in their financial advisors, and for sure they don't trust Wall Street. With very few exceptions, every analyst, fund manager and investment advisor will go on television to claim that this is the time to buy stocks, even though they may themselves be selling. No law will change this, especially when so much campaign money comes from Wall Street." But the real lesson to take from Enron and WorldCom is that financial reporting can never be relied on, and investors need to be armed with skepticism and tough questions.

Coping with the problem

Considering the huge redemptions and the poor outlook for the fresh inflows, mutual funds have a daunting task. Cautioning the fund managers, Hastings says, "Mutual fund managers must be aware of the risk of equity price reversals in the event of inflation and interest rates make a comeback, and it is becoming likely that commodity inflation, the huge deficits in US trade and federal budgets, coupled with monetary volatility make equity a very risky place to be. This is primarily happening right now. At the same time, mutual fund managers must seek new and developing equity opportunities in the developing industrial and service leaders like China and India. Additionally, mutual fund managers must begin to shed 'filler' allocations in large capitalization stocks that pose a risk to total fund performance during periods of market declines." He further adds, "In 'bear markets' large cap stocks act as sources of currency assets and retail investors tend to pull currency out of large caps knowing they can go back later. There are money cycle risks with many large caps during periods of market declines, and we are still in a broader market decline and not on the brink of a new business cycle nor a bull market for stocks."

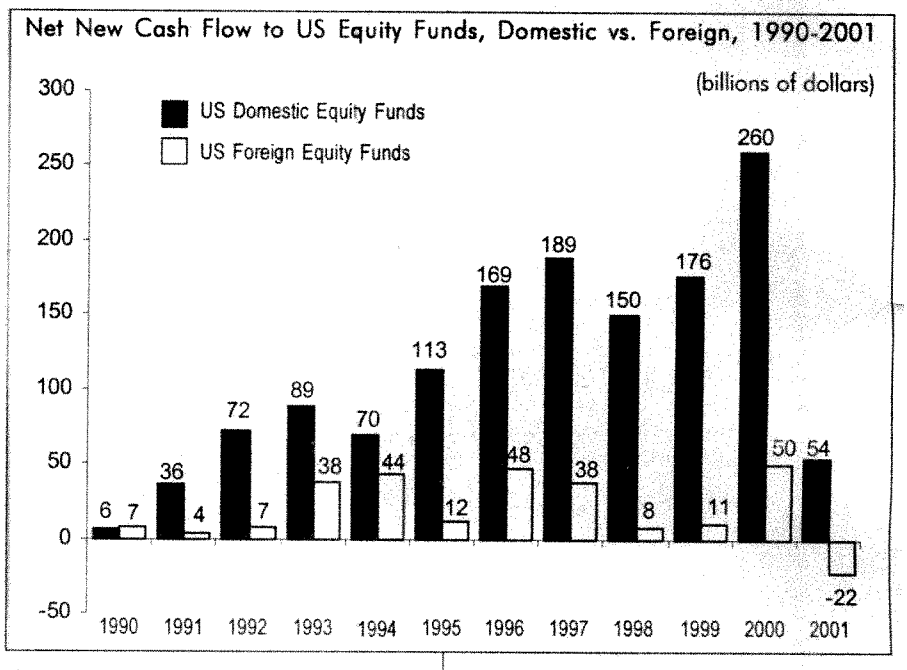
There are a number of reasons why investors should consider allocating a portion of their portfolios to international stocks. Diversifying in this way may help enhance overall portfolio performance while reducing risk. There have been many extended periods when international stocks have outperformed US stocks. More broadly, investing in international

markets increases opportunities; investors who put money only into the US equity market miss out on roughly 45% of the world's total market capitalization. Recently, Fidelity completed work on a research paper about international investing opportunities. It goes into great depth on the potential benefits of diversifying a portfolio into non-US assets. The industry must return to its focus on broadly diversified funds with sound policies, sensible strategies, long-term horizons, and minimal cost. Finger says, "Fund Managers should be able to short stocks. About 95% of mutual funds can only buy stocks or sit in money-market funds. They can't short stocks, and most of them don't even hedge with covered calls or collars. Instead, they get wrapped around the axle with mundane terms such as 'growth', 'value' and 'blend.' Those were nice terms to use during the 1990s bull market, but they're worthless now that a bear market is staring them in the face."

As the era of uncertainty extends this year, investors rather than opting for quick returns will prefer to preserve wealth. Gold has come to be an asset of last resort. There were periodic rallies, but for most part of the past five years, gold was traded at prices below $300 ounce. Gold will always have a historic intrinsic value. In case of global meltdown, people will trade as they did many hundreds of years ago. After years gold made a strong come back as a safe investment in times of international tension.

Future outlook

Considering the rapidly changing investor preferences and developments in the global financial environment, the outlook for the US mutual fund industry remains the same as that of last year. In fact, there is a possibility of redemptions witnessing a sharp increase due to the bleak economic outlook. Commenting on the threat to the US mutual fund industry, Hastings opines, "Mutual fund industry in the US is faced with the risk that the rate of redemptions will increase. It is not the current amount withdrawn but the rate of withdrawals over time that is most difficult for mutual funds to manage. If the rate of redemptions increases too much, too fast, then the expense structure of the fund goes up and the ability to make quality investments is likely to decline. In the end, it takes top quality talent to make sure funds are properly invested and such talent comes with a price. Restoring investors will be next to impossible unless financial statements are more credible." No doubt, ever since Enron, it has been one downhill journey for companies in sustaining their credibility among the investing community. The growing cases of earning manipulations in corporate America have shaken the confidence of investors both in the reporting system and the capital market.



The American system of capitalism is wholly dependent on investor's confidence that was brought into question after the fallout of Enron and the post-Enron events. But still after a series of regulatory reforms, investors will be depending on the credibility in those statements; it will be difficult to restore shareholders' confidence. Regulators have a major role to play in this scenario to regain the trust of investing public. Finger concludes, when he says, "The greatest fear to the mutual fund industry is that investors will get wise. At the bottom of the bear market, investors will realize that the mutual fund industry is stuck in 'forward' and can't switch gears. Then investors will liquidate. Of course, for the investors it will be too late, then."

At the end of the day, the story boils down to chain reaction. Investors blame their brokers or investment planners, who in turn blame the managers of the mutual funds they buy. Fund managers blame corporate mismanagement and malfeasance. And where were all the regulators and reformers when they might have done us the most good? Watching this not-so-merry-go-round ride in operation is more than just a philosophical exercise. It tells us useful things about the human side of what makes markets go, the rationality or the irrationality of human behavior.

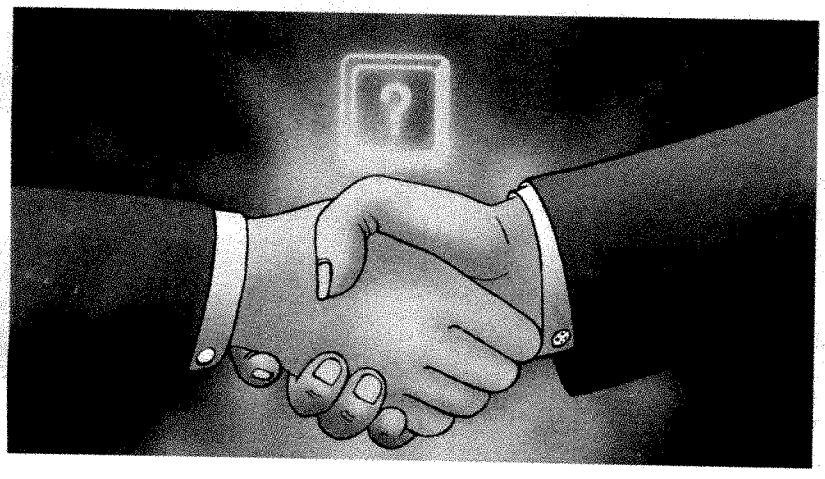
Ajay Hukamichand Shethiya

Reference # 1-2003-05-14

INDIAN MUTUAL FUND INDUSTRY

On a consolidation spree

As a result of poor performance by many mutual funds, investors no longer opt for them. In spite of the market potential, some players are opting to move out of business. This trend is of concern for investors.



In the last twelve months the mutual fund industry has seen a real turnaround on three counts: Mergers and acquisitions (M&A), restructuring of UTI and new scheme launches. The acquisition of Pioneer ITI by Templeton in August 2000, has been one of the biggest ever merger in the Indian mutual fund industry. And while Alliance Mutual Fund had taken back its proposal to withdraw, HDFC Mutual Fund has recently acquired Zurich, making HDFC the second largest private sector fund with assets worth Rs. 10,237 cr, just after Prudential ICICI.

As a result of the HDFC-Zurich alliance, the structure of the mutual fund industry is undergoing a dynamic change. Close to 60% of the net assets of the non-UTI funds are managed by five players: Prudential ICICI, HDFC-Zurich combine, Templeton-Pioneer combine, Alliance Capital, and Birla Sun Life.

In the wake of these developments, foreign players who ventured into India after 1994 are reconsidering their plans. Though the M&A activity has come to the industry, it cannot be said with certainty that foreign players are losing interest in India. The latest exit of Industrial Development Bank of India (IDBI) proves that IDBI has decided to divest its entire equity stake in IDBI-Principal Asset Management Company (I-P AMC) to the foreign joint venture partner Principal Financial Group for Rs. 94 cr. This is due to the fact that Indian market is the most lucrative market for the mutual fund sponsors of AMC as India has the highest savings rates in the world. Thus, there is a sufficient market for mutual funds in India. In spite of the market potential, some players are opting out of business. What are the reasons for these consolidations and will this continue?

Behind the scenes

There may be many reasons for the consolidations, but few of them really aggravate the scenario. One of the main reasons for consolidation is the stagnant growth in the industry, for the last couple of years. According to Irfan Rupani, Senior Manager, Personal Finance, "The foreign players like: Pioneer, Alliance and Zurich are not interested in the domestic mutual fund business as they are not positioned well with their 'global' scheme of things. This indicates that currently, the Indian mutual fund industry is too small for some of the foreign funds to devote time and resources and if they need to pull out from somewhere, India is probably an obvious choice."

There are many things that are responsible for this. Firstly, there was a prolonged bearish phase in equity markets followed by a spate of stock scams that have killed investor interest in equities and equity-linked products like mutual funds. Then, there was the UTI disaster. The UTI case is largely varied and complicated. It first had a US-64 mess and now it has come out with assured return schemes. Recently, there has been talks on its privatization and other developments. It should act fast before it loses its goodwill totally. Being the largest and the oldest AMC, its downfall has badly affected the mutual fund industry and the investors have lost faith in it. Also, during the last couple of years the taxation structure was formed to the detriment of the investors and definitely is a setback to the mutual fund industry.

Apart from the above, returns on mutual fund investments were not attractive enough when compared to administered products like post-office schemes: NSC and PPF, RBI bonds and fixed deposits. Lastly, low investor awareness and perception about mutual funds is also taking its toll on the mutual fund growth. This was the direct result of a very ordinary,

uninformed and unprofessional distributor/agent community that has been governed more by greed than the investors' interests. The only saving grace in the last couple of years is attributable to the spectacular performance by debt funds. Now with interest rate declining at all time low levels, even this growth is losing its momentum.

Lastly, there are some positive aspects of the consolidations that are pointed out by Nilesh Shah, Fund Manager, Franklin Templeton AMC. According to him, "The consolidation will be a function of making 2+2 more than 4 for the combined entity. This process will result in better products synergy, better client coverage and better distribution channel synergy." The consolidation is in a way correcting the scenario in the mutual fund industry. It ensures that the weak bank-based schemes are passed on to the strong base players. This consolidation will also provide economies of scale to existing players in the long run. Thus, this will ensure the investors a fewer and better choice.

As per the provisions of the budget, investors will be able to receive tax-free dividends from their mutual fund investments

But the question as to whether the consolidation is just because of poor growth rates in the industry still remains. The Union Budget 2003-04 has attempted to revive the investor confidence to a little extent. As per the provisions of the budget, investors will be able to receive tax-free dividends from their mutual fund investments. Rupani provides a different perspective when he says, "The Union Budget 2003 may well serve to revive some interest in mutual funds but not because of the dividend tax waiver, as most people believe. The dividend tax waiver will be a short-term measure to boost investor interest and one never knows when the government will roll that back." He further says, "More importantly, the Finance Minister has indirectly lent the mutual fund industry a helping hand by cutting coupon rates on administered rate products by 100 basis points. With this, some of the biggest competitors to mutual funds have lost their sheen and are somewhat on par with mutual funds. The investor will now be forced to look at other options and mutual funds will hopefully appear right on top of his investment options."

Synergies during consolidation

Generally, there are three main areas that the AMC will be concentrating on while going for consolidation: Size of asset base, Percentage of equity assets and Retail participation. The size of the asset base is the most critical aspect as a fund house starts making money only after it garners a critical mass in terms of assets. In the Indian context, most fund houses are still relatively small (less than Rs. 200 cr), so they may be keen to acquire assets by way of takeover to boost their asset base. All the three funds (Pioneer, Alliance Capital, Zurich India) attracted takeover attention largely due to their asset base.

The other important factor that governs interest is the percentage of equity assets. This is because equity assets earn more income for the asset management company and drive profitability vis-à-vis debt. Again in the Indian context, most fund houses are debt-heavy. All the three aforementioned fund houses had an attractive level of equity assets, which made a lot of fund houses to gain interest in their takeover.

The level of retail participation is another criterion that makes a fund house an attractive takeover target. If a fund house has a large retail base it will add to the synergies of the fund house interested in buying it, even if the former has a relatively lower asset base. A case in point is that Dundee Mutual Fund which was also on the buying block could not get anyone to buy it out as it fared poorly on all three counts—low asset base, low equity assets, and low retail investor base. Consequently, the fund will return all monies to investors.

It is really a strange fact but the AMCs generally don't look for any synergies from the investor's point of view before opting for the consolidation. Many times they don't even check the track record of the AMC to whom they are going to sell their stake. The main criterion that matters to them is the percentage of total assets that they are paid as consideration. For example, HDFC has recently acquired Zurich MF. HDFC is known for its conservative approach and management styles. It is famous for its safe and stable returns. The fund house has focused mostly on debt. Hence, its equity assets add up to only about Rs. 300 cr in a total corpus of nearly Rs. 7,000 cr. On the other side, Zurich generally handles aggressive type of funds and follows a totally different approach. Its equity assets add up to Rs. 500 cr in a total corpus of nearly Rs. 3,332 cr. After the consolidation, how the latter would gel with the former is a big question.

Will consolidation benefit investors?

There has been change in the structure of schemes after consolidation, to the extent that the diversified portfolios are converted into sector-specific funds. Thus the investors are justified in raising doubts about the fate of the portfolios, as the management style and the risk preferences change invariably. In case of the

consolidations, are the investors given their share? Now the big question is that can the transfer take place without the consent of the investors?

The investors will be asked but through their authorized representatives, that are the board of trustees. Now who are these board of trustees? They are none other than the supervisors of the AMC or the persons who are closely related to the AMC. Sometimes in the funds sponsored by the public enterprises, the sponsoring entity itself is the principal trustee of the respective fund. Now can any arrangement be more convenient from the AMC point of view? Thus, a consolidation can easily take place without the consent of its investors.

Rupani opines, "In the Indian scenario, the investors are generally ignorant or unconcerned as to what the consolidation could mean to them. The Indian mutual fund industry is still in the nascent stage and so the investors need to be educated thoroughly about how the consolidations could affect them. In India the mutual funds have been sold for all the wrong reasons and so the investors are confused as to how to react when a consolidation takes place. Even the distributors, who have sold the mutual funds, when contacted by the investors later, either do not advise them properly or ask them to switch to another fund in case of consolidation."

Mutual funds have been sold for all the wrong reasons and so the investors are confused as to how to react when a consolidation takes place

All investors, whether or not they are directly affected by such attempts at consolidation, should be aware of the legislative framework on takeovers of funds that has been recently established by SEBI. The market regulator has made it abundantly clear that no change can be effected unless unitholders are given an exit option at the prevailing Net Asset Value (NAV), and certainly without any exit load for at least 30 days. Besides mandatory newspaper advertisements, communication on the proposed change must be made in writing as well. The acquirer is expected also to furnish a draft of the note that unitholders are to receive in due course. The draft should mention the new sponsors' activities and financial performance. They must further assume all responsibilities relating to investor grievances, if any, with respect to these schemes.

Another area of concern for the investors is the status of the respective fund managers and the CEOs. Nothing is usually indicated, and this could be a problem for investors who have shown their faith in a particular fund manager with a long track record is now betrayed.

Future scenario

"The mutual fund industry has a tremendous potential, which needs to be exploited" agrees Nilesh Shah, when he says, "India provides an existing opportunity for asset management business due to high savings rate, expected pension reforms and developed capital markets.

In the early 1990s many asset management companies were attracted towards Indian mutual fund industry due to these factors. After almost a decade, many of them have realized that India remains a distinctly important market but it requires a lot of hard work." He further points out, "The next stage of growth will require higher level of commitment and effort from the participants. They will have to develop new products, which will suit mass-market requirement. They will have to nurture a new channel of distribution, which can penetrate in semi-urban and rural areas. This stage will also be function of the brand and image of mutual fund companies, which will require sustained marketing campaigns and strong geographical presence.

In an uncertain global environment it may not be possible for all existing players in Indian mutual fund industry to provide such level of commitment. Players who are realizing that they will not be able to provide such a commitment are winding down or selling out their Indian operations. This is one of the main drivers for the ongoing consolidation in the mutual fund industry."

In regard to the future of this consolidation scenario, Rupani says that "Fund houses in India that want to make a business out of managing funds will need to do something about increasing their asset size. At the same time, foreign fund houses that have more important things to do than manage money in India, will look to exit. When both these groups of fund houses converge at an appropriate price, it will drive consolidation."

Given the economic conditions and the capital market performances, the process of consolidation in the Indian mutual fund industry may well continue. Larger players would like to have benefits of economies of scale and smaller players will find it difficult to sustain in challenging environment. This may force the industry to go on a consolidation binge, which can restructure the entire industry.

Abhinav Jain

Reference # 1-2003-05-15

BSES

Under Reliance's aegis

BSES, which is struggling with its financials and trying hard to dress up itself from red to black, is, now in the hands of the corporate giant known for its wealth creation. With change of hands BSES will definitely rise to new heights.

BSES one of the leading power companies of the country is in news due to the acquisition of controlling stake by Reliance. BSES is the largest power distribution company in India, distributing approximately 4,000 MW of power, and holds the exclusive license for distribution of power to substantial areas in Mumbai, Delhi and Orissa. The company provides services in electrical contracting, engineering, procurement and construction contracts, computer services, and also operates as an Internet Service Provider (ISP) in Mumbai.

Reliance stake

Reliance which was already the single largest private sector shareholder in BSES, with aggregate shareholding of 44.12% of the subscribed and fully paid-up equity share capital of the company made second open offer along with Reliance's wholly-owned subsidiary, Reliance Power Ventures Ltd. on December 20, 2002 to acquire additional 20% equity in BSES Ltd. at Rs. 230.10 per share which was opened on January 17, 2003 and closed on February 15, 2003. The second open offer was made in pursuance of Reliance's publicly stated objective of acquiring majority shareholding and management control of BSES, in a fair and transparent manner, in accordance with the Regulations. When the second offer closed, Reliance's stake in BSES had increased to 58%. Earlier, the FIIs were reluctant to sell their stake in BSES as they considered Reliance's offer price to be too low and felt that the share price would rise once Reliance takes over the management control but later on had reduced its stake to 1.5% as compared to 2.5% three months ago.

Earlier, Reliance had made an open offer for BSES in May 2000, as a result of which its shareholding in the company had increased from 14.82% to 26.68%. Thereafter, Reliance had increased its shareholding in BSES, through market purchases, made in accordance with the provisions of the Regulations.

Synergy

Reflecting the philosophy of Dhirubhai Ambani, BSES will play an important role in the creation of world-class power infrastructure—in generation, transmission and distribution—keeping pace with regulatory changes and other reforms in this sector. BSES will create value for millions of customers by providing reliable and quality power at competitive prices, with international standards in customer care.

BSES would share the Reliance's philosophy of establishing world-class operations on a global scale, practicing global competitiveness and delivering international quality products and services. BSES, its customers, shareholders, and employees, will benefit from Reliance's proven vision, management strength, project execution capabilities and demonstrated track record of superior operational and financial performance. The group's technical and financial strengths will aid the company in achieving its stated vision of 9,000 MW electricity generation by 2012.

Reliance is pursuing attractive opportunities in the power sector, with the objective of achieving aggregate capacity of over 10,000 MW in the next 10 years. The power sector initiatives represent a strategic fit in Reliance's objective of capturing value across the entire energy chain, as Reliance is pursuing projects with meaningful feedstock linkages. Reliance already has significant power experience in captive power generation, with substantial in-house skills for planning and executing large projects. Captive power generation facilities at its plants at Naroda, Patalganga, Hazira and Jamnagar aggregate over 800 MW. Reliance's various power projects under development have a total capacity of over 6,000 MW. This, together with BSES, existing and future projects of nearly 2,000 MW, aggregates to a capacity of 8,000 MW, making Reliance the largest private sector player in the power sector.

Reliance's overall endeavor will be to accelerate growth plans of BSES, for achieving its vision, and leadership in the power sector. Reliance would derive substantial benefits from convergence of interests in areas such as infocomm and retailing, leveraging on the distribution strength of BSES. With the expected acceleration of reforms and privatization in the power sector, Reliance sees substantial growth opportunities in the future. Reliance is not interested in BSES annuity business. It is keen on the telecom and Independent Power Project (IPP) businesses. BSES holds a considerable advantage in handling IPPs and also caters to over 22 lakh customers in Mumbai. The synergy would help in creating new assets in the power sector to an international scale and magnitude, with enhanced overall

competitiveness. It would provide access to state-of-the-art technologies for achieving optimal operational efficiencies, and highest levels of productivity. The multi-functional synergies would enhance levels of fuel linkages, financial flexibility, accessibility to larger pools of domestic and international capital at competitive costs and would lead to substantial cost reduction. Reliance demonstrated financial engineering capabilities and strengths would give entry into the power trading and derivative markets. Finally, it would extend the geographical reach empowering to offer services to a wider base of customers.

Financials (Rs. mn)

	3QFY02	3QFY03	Change	9mFY02	9mFY03	Change
Sale of electrical energy	6,013	5,680	-5.50%	17,702	18,346	3.60%
Income from EPC, contracts and computer division	1,013	953	-5.90%	3,042	2,455	-19.30%
Total operating income	7,025	6,633	-5.60%	20,744	20,801	0.30%
Operating Profit (EBDIT)	1,490	885	-40.60%	4,222	3,477	-17.60%
Operating Profit Margin (%)	21.20%	13.30%		20.40%	16.70%	
Interest	197	191	-2.90%	497	520	4.70%
Depreciation	507	671	32.30%	1,542	1,954	26.70%
Profit after Tax/(Loss)	868	146	-83.20%	2,488	1,373	-44.80%
Net profit margin (%)	14.40%	2.60%		14.10%	7.50%	
Total expenditure	5,535	5,748	3.80%	16,522	17,324	4.90%

Source: www.equitymaster.com

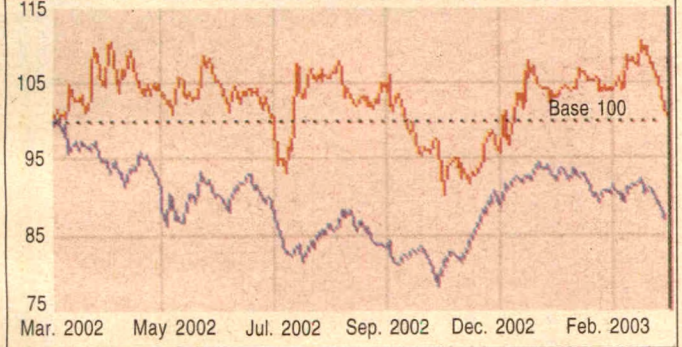
BSES, once a fundamentally strong and well-run company, has been going through troubled times in the last one year. The operating income of the company has fallen down by around 41% while the operating profit margins have shrinked to 13.3% as compared to 21.2% in the previous year. The depreciation provided by the company is also high and has affected the profitability of the company. It has seen a consistent fall in earnings over the last four quarters beginning in January to March 2002. In the latest quarter ended December 2002, BSES post-tax earnings fell by a huge 83% to Rs. 14.60 cr. The company had to withdraw bills aggregating to Rs. 71 cr as "they were raised on an estimated basis earlier". It made a provision for Rs. 24 cr "as a matter of abundant caution". In fact, BSES has been making such provisions over several quarters now but it has not explained the necessity or cause for the same. These provisions serve to depress earnings.

Future outlook

Reliance, which has taken over the management control of BSES, could have a long way to go before it manages to clear the roadblocks that has hampered the growth of the Mumbai-based power company. In particular, the distribution ventures in Orissa and a power generating plant in Kerala have been the cause of sleepless nights for the BSES Board. BSES has managed to get its 165-MW naphtha-fired plant in Kochi finally operational on the eve of the much-touted global investor meet in Kerala. Things are not rosy on the Orissa front as well; BSES has amassed substantial losses from its three distribution circles in Orissa.

Reliance's investment in BSES is driven by a vision of building adequate power infrastructure in India and providing uninterrupted quality power to consumers in a cost efficient manner through optimal operational efficiencies and highest levels of productivity. According to Anil Ambani, RIL would take a 'critical review' of BSES operations in the power sector, especially with its projects in Orissa, Andhra Pradesh, Delhi and Kerala. Reliance wants the city-based power utility to diversify into mutual funds, infrastructure sectors, film production, agriculture, mining and exploration activity and manufacture of telephone instruments. "These are all enabling resolutions which are a regular practice in several companies," said Ambani. Reliance may eventually merge its subsidiary, Reliance Power, with BSES Ltd. after the latter becomes a Reliance subsidiary. "Originally, all Reliance projects were to be executed by Reliance Power, now with BSES coming into its fold, there is the possibility of the two companies becoming one in the future," an official opined. Reliance has repeatedly stated that BSES will be its vehicle for power sector forays. The diversification and consolidation with the Reliance group would definitely contribute towards growth and expansion of BSES in the coming years.

One-year Comparative Graph with BSE



Source: www.equitymaster.com

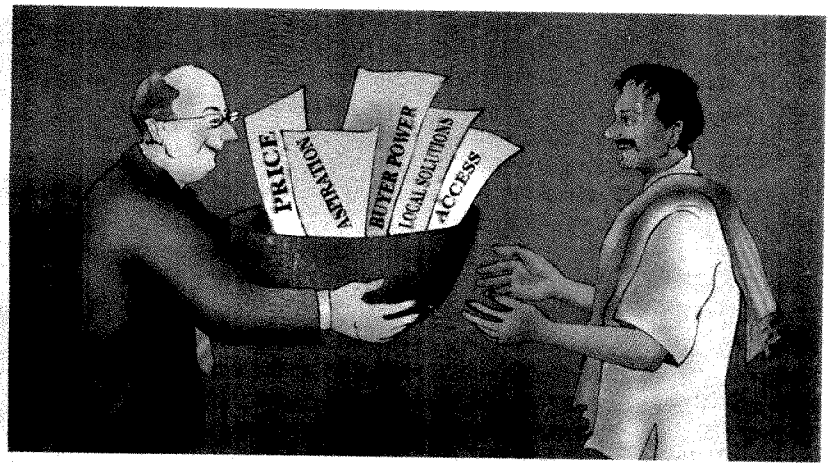
Sanket D Padhye

Reference # 1-2003-05-16

MNCs

Breaking new ground

With a ready market of 4 billion people in lowest tier of the economic pyramid, multinationals have a huge opportunity to improve their bottom line. However, to serve that market, they need to adopt a different approach.



With growth stabilizing in the developed countries, multinationals have to look for growth in the emerging markets of China, India, South-East Asia and Latin America. China is now Eastman Kodak's second biggest film market after the US and sales in China are growing. In India, Gillette has made a strategic shift from its high-end disposable blades and other high-end products to focus on the high-volume mass, double-edge segment. However, these emerging markets have unique dissimilarity from the developed countries, the aspiring poor. According to Prof. C K Prahalad and Prof. Stuart L Hart in the article *The Fortune at the Bottom of the Pyramid*, "the real source of market promise in these emerging markets is not the wealthy few or the emerging middle-income consumers. It is the billions of aspiring poor who are joining the market economy for the first time."

The size of this huge Tier 4 market is 4 billion and is increasing. Prof. Andrea Hershatter, Assistant Dean and Director of the BBA Program, Senior Lecturer in Organization and Management, Goizueta Business School, Emory University says, "the question is whether the current portfolio of goods and services available on a worldwide basis can be delivered to the market that desires and can afford them at a reasonable profit."

Companies, irrespective of being global or domestic, are reluctant to target these aspiring poor as their prospective customers. Most companies ignore the bottom of the pyramid (Tier 4) because they judge the market based on income levels of the consumers or by selection of products and services, which are mostly designed for the rich customers or customers of the developed countries, who reside at the top of the world economic pyramid.

Some companies have tried to sell to these aspiring people, cheaper product variants of their existing products, but they were inferior in quality. However, most of such strategies failed. TCL, a Chinese television company entered India in the late 1990s hoping to sell cheap color television to the lower end of the market, which boomeranged.

Serving these aspiring poor is not same as serving the existing markets better or more efficiently. Prof. Andrea Hershatter observes, "companies must first address whether or not these populations can accurately be considered as potential consumers. For that two conditions must exist. First, they must have been able to adequately satisfy their more base level human needs with sufficient discretionary income remaining to be eligible to participate in the marketplace if they desire to do so. Second, they must be culturally and socially disposed towards pursuing a market-oriented consumption base lifestyle. Neither of these two conditions is a given and the first does not necessarily lead to the second."

Characteristics of aspiring people

The 4 billion people in the Tier 4 segment live in urban slums, shantytowns and rural villages. They aspire to buy the products and services offered by the multinationals, but they do not have enough disposable income to afford them. Their annual per capita income, based on purchasing power parity in US dollars is around $1,500. According to C K Prahalad and Hammond Allen, in the article *Serving the World's Poor, Profitably*, in Dharavi, a slum (Asia's largest) in Mumbai, India, 85% own a TV, 75% own a pressure cooker and a mixer, 56% have a gas connection and 21% have telephone connections. They have little or no formal education and are highly illiterate. These people are also very

highly price-sensitive and are loyal to local customs, habits and often to local brands. However, due to price-sensitiveness, they are prone to switch brands. Hence, companies need to pursue high-volume sales with low margins, instead of low-volume sales with high margins. They are also not very fussy about quality. However, very poor quality is also what they do not look for. As a result, to serve the customers of Tier 4 the conventional distribution, credit and communication systems are rendered ineffective in order to reach them.

Key elements for success in Tier 4

Besides price, the other key elements for thriving in the Tier 4 segment, according to Prof. Prahalad and Prof. Stuart are creating buying power, shaping aspirations, improving access and tailoring local solutions.

Price

MNCs tend to bring their existing products at a much higher price and follow marketing strategies that are not in sync with what is required to sell to the consumers at the bottom of the pyramid. Hence, they end up serving the high-end niche players. That is what happened to Kellogg's in India, when they launched their breakfast cereals in the early 1990s. Only the high-end consumers with high disposable income were able to afford Kellogg's cereals. Kellogg's has never been able to penetrate the Indian mass market because of its high price and the company is losing money.

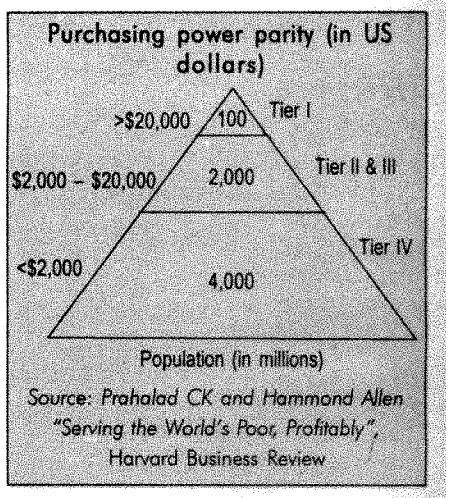
In reality, consumers in the Tier 4 segment are highly price-conscious. This gives the local or regional companies an edge over the MNCs

In reality, consumers in the Tier 4 segment are highly price-conscious. This gives the local or regional companies an edge over the MNCs in the Tier 4 segment. The success of Nirma is an example. In the late 1980s, Nirma started offering detergent products and later toilet soaps for poor consumers mostly in the rural areas. Today, the brand Nirma has become so popular among the Tier 4 people that it has captured a market share of nearly 35% by value in the detergent segment and 20% market share in the toilet soap segment. In cassettes, the T-Series brand was extremely successful with its low pricing and at the same time providing value with its more songs per cassette. Recently, Ratan Tata, Chairman of Tata Group, has announced that Tata is planning to manufacture a car made from different low cost components like cycle parts, which would be priced at Rs. 1,00,000. At such a price, it might be able to expand the car market by attracting new customers with lower disposable income and also by luring away some of the existent two-wheeler users.

Creating buying power

For any products to sell, consumers need to have disposable income. The consumers in Tier 4 segment have desire to buy products, but they do not have the purchasing capacity as majority of the products are priced at higher. To meet their desires, companies need to take steps so that these customers could have access to credit and have higher earning capacity. Many companies, however, might argue that it is not their responsibility to increase the earning capacity of the consumers or make it easier for the consumers to get access to credit. A few companies, however, proved it wrong. Way back in 1920s, Henry Ford increased the wages of his employees to increase the sales of his Ford cars and he was successful.

Hindustan Lever Ltd. (HLL), the Indian subsidiary of Unilever,



Source: Prahalad CK and Hammond Allen "Serving the World's Poor, Profitably", Harvard Business Review

has started a program targeting villages with a population of less than 2,000. Under the program, the company provides self-employment opportunities to villagers through Self-Help Groups (SHGs). SHGs operate like direct-to-home distributors wherein groups of 15-20 villagers who are below the poverty line (Rs. 750) are provided with an opportunity to take micro-credit from banks. With the help of this money, villagers are able to buy HLL's products and sell them to other villagers, thereby generating employment and income for themselves and also increasing the reach of HLL's products.

Generally, the poor have difficulty in getting access to commercial credit, as the traditional banking system does not normally lend money without collateral. However, some institutions, like the Grameen Bank in Bangladesh, are helping the poor to access money through innovative solutions such as micro-lending. In the Grameen Bank model, one group of rural women took out a loan for as little as $25 to start a business. Only when she repaid could the next woman in the group borrow.

The success of Grameen Bank has helped to spread the idea of micro-lending throughout the world. In Bangladesh alone, there are now around 10 million people who have taken the help of micro-finance to start business. It is now

planning to replicate the success in rural India. The success of Grameen Bank had also led to its offshoot, Grameen Phone, a provider of village phone service. As mentioned in the article *Serving the World's Poor, Profitably* by Prahalad C K and Hammond Allen, under Grameen Phone, a single entrepreneur in a village borrows money from Grameen Bank to buy a mobile phone (GSM standard), which is being used by the entire village generating an average monthly revenue of around $90 for the entrepreneur.

Shaping aspirations

As already mentioned, the consumers at the bottom of the pyramid are mostly uneducated and illiterate, the companies need to spend time and resources to educate the consumers.

HLL, under its 'Project Bharat', visits villages where company sales representatives explain to the rural people the benefits of HLL's products and how to use the products with the help of video shows. This creates awareness of HLL's product categories and addresses the issues of attitudes and habits of the rural people. For example, only three out of 10 people in rural areas of India use toothpaste or talcum powder; or shampoo and skin care products; and only six use washing powders. Even in categories with high penetration, such as soaps, consumption is one per five bathing occasions. Till 1999, HLL was able to reach 13 million village households.

The lack of storage, handling and transport facilities aggravates the situation resulting in huge wastage (8-11%) and low processing yields

In 2002, ITC, one of India's largest consumer product and agri-business companies, launched 'Project Symphony', under which e-choupals are launched in villages in some Indian states. Through these e-choupals, farmers could use computers and access the Internet to conduct their business. Normally, the illiterate and gullible agri-farmers in India are also forced to sell their produce at low prices to the traders, who act as middlemen and cite the reasons of poor quality or weak demand for low price. The farmers also face the problems of small regional markets and no standard grading systems for their produce. The lack of storage, handling and transport facilities aggravates the situation resulting in huge wastage (8-11%) and low processing yields. With e-choupals, farmers access the daily market prices of their crops in addition to information on best practices in farming and weather forecasts. The farmers then sell their produce at collection centers taken on lease by ITC, at a higher price than they used to get before and at the same time, the transaction costs involved in selling farm produce are also reduced.

Improving access

Prof. Hershatter opines, "Many consumers in Tier 4 are in locations that make distribution extremely difficult." The old distribution system no longer holds good.

To make sure that the consumers in the Tier 4 segment have access to the products, the distribution system followed by the companies should be different from that of their existing systems. Lack of motorable roads in India makes the distribution costs high and the reach low. HLL has realized that, for improving access of its products in rural areas, the traditional distribution channels would increase costs, which would ultimately increase the price of the products. The company has experimented with innovative methods to reach the rural consumer.

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>
> **Prof. Andrea Hershatter**
> *Assistant Dean & Director*
> *BBA Program*
> *Senior Lecturer in*
> *Organization and Management*
> *Goizueta Business School*
> *Emory University*

Under its 'Indirect Coverage (IDC)' method, company vans were replaced by vans belonging to Redistribution Stockists, which serviced a select group of neighboring markets. HLL also uses the service of 'mobile traders'. These mobile traders travel either on foot or on cycles, thus more effective on cost and reach than the conventional wholesale distribution channels. Besides, these traders target smaller villages, those with a population of less than 2,000, which conventional distribution channels often cannot reach. There is also the crucial issue of buying behavior. Most rural women are reluctant to visit retail outlets on their own. Instead, the village women rely on the mobile traders for purchasing their needs. Another company, Perfetti India, uses 'candy boys' to service small retailers in rural India.

The success of Legend Computers in China is also attributed to its efficient distribution system. Legend sells its low-priced PCs to smaller cities and towns where the US and European PC companies, have not yet been able to penetrate. Legend Computers, which was once only a

wholesale distributor of the US and European computer companies, has now become the number one PC manufacturer in China with a market share of 30% in 2002 and is also one of the world's fastest growing computer technology company.

Tailoring local solutions

Most of the global products that multinational companies manufacture are primarily for the Tier 1 consumers of the global markets. These global products are then also sold to the Tier 4 consumers, with least thought given whether those products are suitable for the Tier 4 consumers. Inevitably, most of such global products fail to fulfill the needs of the Tier 4 consumers.

Prof. Hershatter views, "other than medication, most branded items marketed on a global basis can best be described as luxuries. They ease tasks or provide additional comforts and conveniences, or establish a person as belonging in a specific milieu." To be successful, MNCs need to nurture local markets and provide local solutions depending on the culture and consumer habits of a particular market.

To be successful, MNCs need to nurture local markets and provide local solutions depending on the culture and consumer habits of a particular market

For example, Prof. Prahalad has recently commented that for FMCG companies to sell more in the rural India, they have to be innovative in the delivery format. In India, the Tier 4 consumers, because of higher price, earlier did not often purchase the shampoos sold by MNCs. Buying in small quantities is also practiced by the laborers in the urban areas of India who are being paid on a weekly or daily basis. Many of them stay in single rooms or huts with little space. Lack of cash and space makes these people to shop everyday in small quantities and hence single-served sachets have become popular. Once the multinational companies started selling shampoos in single-served sachets priced at 50 paise/ Re. 1, the sales of shampoos have increased to the extent that 30% of the personal care products are now sold in single-served packages. Sachets are no longer restricted to shampoos only; they have penetrated to other products such as edible oil, tea, jam etc. Also, the sachets give these buyers an option of choosing different brands without locking too much cash.

The role of technology

From times immemorial, technology has played a very important role in serving mankind. Be it the telephone to communicate or the cars to transport goods cheaply between places. With the help of technology, it is possible to spur micro-enterprise and economic developments and empower consumers in the Tier 4 segment.

Technology for renewable energy such as solar power has helped to expand the market for various products. The advent of Internet and advancement in information and communication technologies has not only reduced that problem but also became a powerful source of economic leverage for the consumers in Tier 4. For companies, the technological advances have become an inexpensive way to establish marketing and distribution channels in the Tier 4 segment. ITC's success with e-choupal demonstrates the importance of technology in serving the poor farmers in remote Indian villages.

Conclusion

Pricing, creating buying power, shaping aspirations, improving access and tailoring local solutions, the five elements of success in the Tier 4 segment and technology are all intertwined. Each is vital for creating profits from the consumers at the bottom of the pyramid.

But, succeeding in the Tier 4 markets is a challenging task. It requires more than money. To be successful at the bottom of the economic pyramid, the biggest change needs to come in the attitude and thinking of the CEOs and the managers. Managers have to have a new way of looking at their existing business practices. They have to discard their traditional beliefs and attitudes, which are attuned to serve the Tier 1, 2 and 3 segments. That change needs to be brought about by the CEOs. Prof. Hershatter also agrees. According to him, "the strategies and tactics needed to reach this consumer market must emerge from the top."

To effectively tap the opportunity in the big emerging markets, multinationals have to reconfigure their resource base, rethink their cost structure, modify their distribution systems, re-evaluate the price-performance relationships and redesign their product development process.

Companies also have to redefine the concept of scale, from 'bigger is better' to highly distributed small-scale operations with world-class capabilities. Prof. Hershatter opines, "The only socially responsible way to think in this context is to focus on how to develop a self-sustaining community along with a marketplace. To the extent that the local community participates in production and profitability along with consumption, I think there is a viable and valuable world market."

Anindya Roy

Reference # 1-2003-05-17

INSURANCE BRANDING

The new mantra

Increased competition is forcing the Indian insurance companies to distinguish themselves from one another. In an attempt to establish themselves, private players are gearing up to build strong brands.

The Indian insurance industry is still at its nascent stage. With a population of over a billion, only a very small percentage of it is actually having insurance cover. Undoubtedly there is a large untapped market, which is attracting a host of foreign and private players. In addition, a host of banks are operating in the insurance sector in the form of bancassurance companies.

The liberalization of the sector has created an opportunity for the private players to enter the market and unleash the full potential of the market. Now the competition is heating up with almost more than 10 players in each segment (life and non-life). The competition in the sector can be classified in two ways: New players competing amongst themselves to carve a niche and competing with insurance giants like LIC and GIC in their respective segments. The changing scenario is forcing the players to differentiate themselves from others. Just like any other product, insurance companies are now examining the possibility of branding their products and services to fuel growth.

Why branding insurance?

Manufacturers over the years have used branding as an effective tool to sustain the business. But in recent times even service companies have realized the importance of branding and are now emphasizing the development of strong brands. Consider the Indian insurance industry. In India, of the various financial services, insurance industry was probably one, which has historically given least importance to branding. This was because of the limited presence of insurance companies in the form of LIC and GIC coupled with people's limited understanding of the necessity of an insurance policy. But the same luxury can no longer be afforded now, especially with the opening up of this sector and the resultant presence of a number of MNCs in the Indian market. Insurance companies are now investing their resources to build strong brands. But services are difficult to differentiate. Typically any new service that is launched by a company can be easily copied by competition. This reinforces the importance of having a strong brand. M Anand, CEO, Bimaonline.com says, "Insurance is a sector where products and services are more or less commoditized. Whenever a company comes out with an innovative product, in no time competitors launch similar products. In such a scenario branding helps customers choose an insurance company over its competitors."

Branding can also be effectively put to use to retain the customer confidence, which is critical for services like insurance. Typically insurance customers look out for trusted names than opting for a new player. It is here that the well-established players like LIC and GIC have an edge over the competition from new players. This is precisely the reason why most foreign players entering into India

> **While insurance brands are not yet ingrained with insurance buyers, current advertising campaigns are definitely making progress in that they are effectively building familiarity and favorable impressions of each brand.**
>
> **M Anand**
> *CEO*
> *Bimaonline.com*

are tying up with some already established Indian companies because even they are finding it foolish to jettison the existing names. Moreover, advantages of this are enormous. First, the foreign company gets to have an idea of the span of the Indian market even before entering the same. They will also have the muscle power of fighting the domestic biggies like LIC and GIC. Examples may be Prudential tying up with ICICI, Allianz tying up with Bajaj or AIG tying up with Tata. According to Asutosh Bishnoi, Vice-President OM Kotak, "In life insurance the minimum expectation that a customer has is that the company will survive him. To that extent all brands must provide comfort that they will be around for a long time. Foreign and unknown brands in Indian life insurance sector need to overcome this 'barrier'".

Challenges in insurance branding

Essentially, insurance products are push products and not pull products. Media advertisements are used for creating awareness and image. But generally sale happens through personal meeting, counseling and sometimes persuasion. Besides, many of the insurance products are quite complicated and would require a qualified insurance advisor to suggest the right product to the customer. However, some basic products like personal accident policy or term insurance policy or auto policy can be sold through Internet and direct mailers. This kind of direct sales campaign can be quite successful if it is complemented by TV and mass media advertisements.

The positioning of the Chennai-based company Royal Sundaram 'Beyond Expectations', and an association with cricket—with a pavilion at Chepauk Stadium—helped creating an image of a sporty, accessible company. ICICI Prudential has used a high-decibel multimedia campaign to position insurance on an emotional platform (of protection) rather than merely a rational one (of tax savings). It has created a ticker symbol in its homepage where a person can get personalized information for the particular policy he can opt for. Om Kotak Mahindra's commercial shows a man imagining his future *"...ek din mein apne aap se mila."* All of life's future concerns were brought out with compassion and empathy.

A major hurdle for insurance companies in India is the task of convincing people about the need for an insurance policy since most still feel that they don't need one. As a consequence most advertisement campaigns are still in the stage of building awareness on the need for insurance, establishing the company's credentials and creating good value associations. Brand building for specific products is still something far-off. But things are slowly changing. According to Anand, "While insurance brands are not yet ingrained with insurance buyers, current advertising campaigns are definitely making progress in that they are effectively building familiarity and favorable impressions of each brand by effectively communicating and constantly reinforcing the same messages with insurance consumers over a period of time."

In India, while new entrants have been banking on their innovative products, better service and experience of their foreign partners to capture the market, domestic insurers are defending the market share by focusing on the familiarity with the Indian market, size and better understanding of Indian culture and values. To give an example, LIC has been advertising with the punch line 'We know India Better'. The company has also increased its advertisement budget to Rs. 110 cr for 2002-03 compared to Rs. 80 cr for 2001-02.

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> *Vice-President*
> *OM Kotak*

This apart, they are providing toll free lines to attend to customer queries, making provisions for online payment of premiums, online tools for customers etc. All this seems to be an exercise to enhance the customer experience and match their service standards with that of the private insurers.

All these efforts are helping the companies to build strong brands. The onus now lies on the companies to change customers' buying criteria that have usually been the price factors. Branding helps companies to rise above the clutter and helps them to have a better knowledge of their products that in turn helps customers to make a choice easily. Anand has a piece of advice for insurance companies, "By identifying the set of values, which a brand stands for, and effectively communicating to the consumers, companies can provide understandable reasons for the consumers to choose their products. Though no amount of branding can replace pricing as the deciding factor, branding can provide supplementary differentiating influences for a purchase decision."

Suddha Satwa Aich

Reference # 1-2003-05-18

The Impact of Financial Liberalization

Over the last three decades, there has been a move towards liberalization of financial markets across the world. What has been the impact of liberalization of financial markets? Has liberalization increased or decreased the frequency and magnitude of the boom and burst cycles? These are the questions this research paper attempts to answer.

The 1990s may be termed as a tumultuous decade for the capital markets across the world. Economies crumbled in the light of some currency as well as stock market crises that occurred during the decade. One of the characteristic features of the decade was liberalization of financial markets, which had been accused as one of the causes for the umpteen crises.

There are two schools of thought on the issue of financial controls. One school insists on returning to an era of capital controls with both the inflows and outflows being controlled so as to minimize the impact of economic crises. Another school of thought encourages financial liberalization citing all the advantages such as improved functioning of the financial systems, increased availability of funds and cross-country risk diversification. Both parallel thought streams have empirical evidence to strengthen their own argument, but the important element of time is not included in their studies. This paper attempts to factor in the issue of time i.e., it tries to observe what is the impact of financial liberalization on economic cycles in the short-run (immediately after financial liberalization) and in the long-run (four years after financial liberalization). In addition, the paper also considers mature markets rather than focusing on emerging or developing markets alone for empirical evidence.

The path to financial liberalization

For the purposes of study, data on 28 countries for the period between 1973-1999 have been taken. These countries can be divided into mature economies and emerging economies. They are also divided region-wise as Asian, European etc.

Financial liberalization includes elimination of controls in three crucial sectors—capital account, domestic financial sector and the stock market. For each sector, three regimes have been identified: 'fully liberalized', 'partially liberalized' and 'repressed'. On the whole, a country is considered to be fully liberalized if more than two sectors are fully liberalized and the third one is partially liberalized. A country is partially liberalized if at least two sectors are partially liberalized. This understanding is significant because in many cases deregulation of the financial system does not happen at one go. It is a gradual process, where each sector is free from restrictions in a phased manner. For the purpose of analysis, the index was created with value one indicating fully liberalized and three indicating fully repressed financial systems.

The result: Matured financial markets are on an average less regulated with a score of 1.7. Emerging economies, on the other hand, had an average of 2.3. One of the interesting findings was that there is gradual lifting of restrictions across all the regions over the period. Emerging markets displayed an additional trait of liberalization reversals in the early 1980s following the debt crisis. In contrast, the path of the matured markets was generally uninterrupted and smooth.

There is also a distinct difference to the approach mature markets and emerging economies adapted to the liberalization process. Most mature markets were already liberalized by the early 1970s. In these markets liberalization of the domestic financial sector also predates the opening of the capital account. By the mid-1980s most matured markets had at least partially liberalized their domestic financial sector. It was only in the late 1980s and during the early 1990s that capital account liberalization was seen in mature markets partly prompted by the formation of the European Union.

The liberalization process in emerging economies can be seen in two episodes. The first one in the late 1970s when the action was concentrated in the domestic sector and capital account with stock markets largely left untouched. This episode came to an end with the debt crisis of 1982. The second episode of liberalization started during the late 1980s when the domestic sector and the stock market were deregulated before capital account liberalization was undertaken.

There are also some regional differences in the path to liberalization. G-7 countries deregulated the stock market first,

Summarized version of IMF Working Paper (WP/03/34), "Short-run Pain, Long-run Gain: The Effects of Financial Liberalization" by Graciela Laura Kaminsky and Sergio L Schmukler.

European countries used a mixed strategy with 25% of the nations' liberalizing domestic financial sector first while the rest deregulated the stock market first. Most of the North American countries adopted liberalization of domestic financial sector first while their Asian counterparts adopted a mixed strategy of either deregulated domestic financial sector or stock markets first.

Liberalization reforms took a long time to be completed. On an average, it took 66 months that is more than five years, from the time the first market was liberalized. Another interesting revelation was that the time to complete liberalization reform was far longer in Asia than in Latin America. In addition it was also observed that liberalization episodes that were first implemented in the stock market were the ones that became complete the fastest.

The impact on financial cycles

Does this process of financial liberalization have an impact on the booms and bursts in the country? It sure does. The entry of foreign investors changed the dynamics of the game drastically. The impact of economic cycles is magnified by the increasing presence of institutional investors, which tend to follow momentum-based fads (buying stocks that are past winners and selling past losers) and by the presence of asymmetric information that leads to herding.

Event studies were done to analyze the behavior of stock markets in the aftermath of liberalization relative to their functioning in repression times. They revealed that the amplitude of booms substantially increases in the immediate aftermath of liberalization (about 20% higher than during repression times). But equity markets stabilize in the long-run if liberalization persists, with the amplitude of boom about 25% smaller than in repression times. Similarly, the amplitude of crashes increases in the immediate aftermath of liberalization (about 15% higher than during repression times), but declines to about 60% of its size during repression times if liberalization persists in the long-run.

In the case of emerging markets, the short-run effects of liberalization are more striking, with booms and crashes in the immediate aftermath of liberalization increasing by 35% over their size during repression. Still, if liberalization persists, financial cycles become less pronounced, with booms about 30% smaller than during repression times, and crashes about 90% of their size during repression times.

In the case of mature markets, evidence indicates that if liberalization triggers more volatile stock markets in the short-run, booms and busts do not increase as much as in the case of emerging markets. On an average, crashes do not increase relative to their value during repression times. Liberalization seems to create more stable financial markets in the long-run, with crashes averaging only about 60% of their size during repression times.

Financial liberalization triggers larger cycles in the short-run and stabilizes financial markets in the long-run. The short-run effect of financial liberalization is more pronounced if both the foreign and domestic factors are controlled. Evidence suggests that larger booms follow liberalization in both emerging and mature markets whereas, it is only in emerging markets that crashes are more severe following liberalization.

Impact of sequencing

In a situation where each sector is opened phase-wise, the increase in the amplitude of the booms is similar following the first and the second opening, but crashes in the immediate aftermath of the first opening are smaller than those observed during repression. The amplitude of crashes in emerging markets only increases after the opening of the second sector.

Does deregulating domestic sector or stock market first have an impact on the booms and crashes? Not much as per the evidence. In general the specific order of financial liberalization has no impact with one exception i.e., crashes seem to be larger in emerging markets if the capital account is deregulated first. Another interesting observation is that crashes are more pronounced not at the beginning of liberalization reform but after few years.

Reasons

The increase in institutional reform, the participation of foreign investors and the integration with world markets which tends to speed up the reform process all work towards achieving a stable financial system in the long-run.

There is a debate on whether institutional reform precedes or succeeds financial liberalization. Evidence for emerging as well as mature markets suggests that institutional reform occurs mostly after liberalization is implemented. Law and order including insider trading regulations and persecutions improve only after partial liberalization. While systems are in place prior to financial liberalization, their effective implementation has been observed after liberalization. There is enough evidence to suggest that partial liberalization fuels institutional reforms.

Secondly, financial liberalization brings in competition and also participation from foreign investors who are generally in a better position than domestic investors in emerging economies. Thirdly, the integration with world markets and institutions tends to speed up the reform process and creates a resilient financial system. All these three factors contribute to the positive impact of financial liberalization in the long-run.

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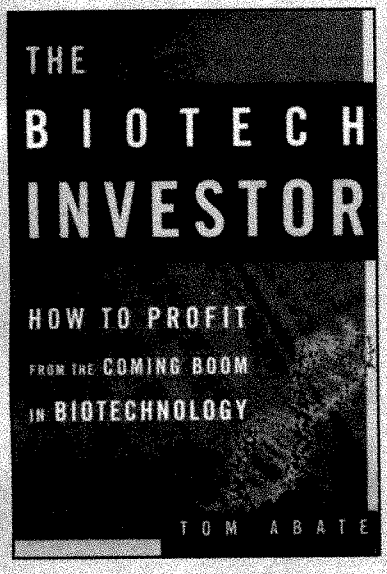
BOOK SUMMARY

The Biotech Investor

How to Profit from the Coming Boom in Biotechnology



Author: Tom Abate
Pages: 290
Price: Rs. 1395
Publisher: Times Books

Biotechnology has emerged as a new investment avenue. In a mad rush to benefit from the ongoing surge in biotech activity many investors have burnt their fingers. In order to succeed as a biotech investor, there is a strong need for patience, research and systematic approach.

Biotechnology has come a long way. The genesis of this hot new sector can be traced back to 1953, when two scientists James Watson and Francis Crick, made an obscure discovery of the DNA molecule. The finding marked the discovery of mechanisms of life. Starting with that discovery, over time, other scientists worked on DNA and cracked the chemical code locked up in the DNA molecule. It was identified that DNA created RNA, which in turn created proteins, the chemical agents that perform every task of the body. With more and more companies engaged in the field of biotechnology, the investment aspects crept in. With every new breakthrough in the understanding of human body, there is a promise of new medicine and treatment.

Considering the huge growth potential for biotechnology in the next century, there is a rising interest in biotech investing. The growth of aged population in the developed world is creating a huge new market for medicines, which together with the new treatments forms the rationale for biotech investing.

From science to market

The reason behind biotechnology attracting investors is that it offers a radically different way of discovering medicines. The success stories of Genentech and Amgen in the US during 1980s has reinforced the confidence of investors in this sector. But in the hype surrounding biotech investing, many investors fail to understand that biotechnology does not produce results over night. Just like high capital-intensive industries, biotech companies do have long gestation periods. Although biotech companies raised billions in venture capital and in equity during the 1980s, only 18 approved medicines were available in the market by the end of the decade.

With ready access to cash, why did the biotech companies take so long to make it to commercial production? There are two

reasons for this. First, the US Food and Drug Administration (FDA) along with other bodies imposes strict testing requirements before an experimental medicine is sold. Second, when approved medicines rarely sell themselves. The large drug companies have created a huge salesforce, which persuades the physicians to use new medications. The twin barriers of winning approval and building an international salesforce have bedeviled the biotech industry and slowed the progress of the sector. However, during the 1990s, the industry learned some lessons and picked up the pace by getting another 125 medicines.

Investors who wish to invest in biotech companies need to remember that for every 250 compounds that undergo preclinical test, only five go into human clinical trails. The success rate is too low and the process is too long. The five compounds have to undergo another three phases of human trails that are prerequisites for medicinal approval. Out of the five, only one can get the approval from the FDA. The three phases of studies are more demanding and expensive. Moving from a few dozen volunteers in the first phase, the second phase will involve hundreds of patients, and in the final phase, the number of patients can move up to millions of patients. The expenses for running the three phases of experimentation can soar to tens of millions of dollars. Once the phase III trail is successful, the company can go for a commercial production. However, the FDA will clear the drug only if its advisory board votes in favor of the new drug. Investors have to be alert in this regard as the company in spite of successful clinical trails has to obtain the permission from the FDA. It is not a medicine until the FDA says it's a medicine.

Investors who wish to invest in biotech companies need to remember that for every 250 compounds that undergo preclinical test, only five go into human clinical trails

About the Author

Award-winning journalist Tom Abate is one of the nation's most influential observers of the biotechnology industry. Technology, biotechnology, and health care reporter for the *San Francisco Chronicle* since 1997, Abate writes the weekly 'Bioscope' column.

So for the investors, what points in the development cycle offer the best risk-to-reward ratio? The overall returns will be better when investors wait until the positive advisory board vote or even until the company starts to demonstrate real earnings. The waiting game is not the only strategy that investors have to follow. Successful investors as of now have learnt that selling is more important than buying in biotech. Investors who prefer a buy-and-hold strategy should concentrate only on a handful of biotech companies that are already profitable since these companies' stocks will move on earnings.

The investment rationale

Considering the uncertainty about the success of the clinical trails and final commercial production, why should investors invest in biotech industry? For decades, drug companies are the most profitable companies in rankings done by *Fortune* magazine. The margins in this industry can reach 90% and considering these facts, it makes sense to invest in this industry. By the time the medicine is approved, the cost of manufacture, sales and distribution are negligible in comparison to the risks and expenses already undertaken. Apart from that, there is a strong conviction that the market for medicines will expand tremendously in the next 20 years with rapidly changing demographics. An aging population has arisen at just the time when an increasingly sophisticated biotech industry has aimed itself at unmet medical needs. This is the central rationale for biotech investing.

While investing in biotech companies, investors should pick investment targets by looking at diseases areas. By specializing in specific diseases, the quality of research can be improved and thereby a reduction of inherent risks in biotech investing can be reduced. Some of the niche areas or specialized areas that investors can look out for are the cancer market, which is again subdivided into antibodies, vaccines and anti-angiogenesis. Other areas that can be considered include central nervous system disorders and cardiovascular diseases.

In order to identify the investment focus and take the subsequent research—investors have to begin with the area that interests them; use the available media and reports from various associations to know more about the disease or disorders; identify the unmet medical need in that particular segment and also identify the products and trails that are focused on that particular segment. Since most of the small biotech firms do not have the financial power to complete the trails they will be looking out for some assistance from the prominent drug companies. At the same time, for drug companies to deliver the earnings growth which the stock markets expect, need to bring a steady stream of new products to market. Since both the parties involved have synergies out of the partnership, it is important to look out for those kind of partnerships and study about the long-term alliances that can be formed.

The genomic wave

With the first rough draft map of human genome, the public fascination towards biotechnology reached its peak. As many as 60 initial public offerings were announced during 2000. During the year biotech firms raised in excess $32 bn using IPOs, secondary stock offerings, venture capital investments, debt offerings and other equity instruments. The public fascination to human genome was based on the belief that mapping of human genome would quickly point the way to cures. This belief by the public enabled the creation of new wave of biotech companies. Investors have failed to understand that the new biotech companies have just begun their drug discovery marathon. Investors have to approach these new firms with realism and skepticism. In fact, mapping of genome was the easiest part, converting this knowledge into products and profits is the toughest part.

While investing in the genomic sector, investors find that this sector is no different from other sectors of biotechnology. Companies are fascinating, their work having the potential to develop new medicines. But most companies are in various stages and are losing money. Even the immediate future appears to be bleak. Then, how the investors can decide the best time and price to make a purchase? The most consistent, honest and reliable yardstick for comparing stock prices is by measuring the biotech companies against their peers. To become a successful biotech investor, individuals need to learn and recognize the neighborhoods of biotechnology and the factors that make some firms as a part in each niche market and others as fixer-uppers. Individuals have to become experts in relative values. Focus research and make investments based on sound understanding of the relative values of the stocks in the niche that becomes the target. Then investors can track all the stocks in the niche. Apart from tracking the stock prices, other variables that are important to be considered before making a investment decision are: Cash position, quarterly expenses, income, net income, years of cash, product pipeline, management and market capitalization. The true art of investing is detecting or predicting changes as to whether it is a sector leader heading for a crash or a laggard gaining ground.

Investors have failed to understand that the new biotech companies have just begun their drug discovery marathon

The proteomics

Think about any industry that has endless frontiers to its credit and biotechnology will be the first one to strike. Proteomics is the systematic study of the role that proteins play in maintaining health and causing diseases. Proteomics companies are attempting to invest high speed instruments and techniques to industrialize the study of proteins and find new drug targets in less time than is presently possible. However, compared to the field of genomic, this field is still at an infant stage. Though most of the companies in this field are privately held, the possibility of them going public will depend on the enthusiasm that this field creates among the investing community. The markets can dwell on the hype that proteomics will zero in on disease at more fundamental level than genomics, since proteins are more closely related to disease than genes.

The problem with the biotech industry is that it is too specialized. The industry is characterized by too many companies that excel in one stage of the drug discovery puzzle. They cannot develop a blockbuster product or profits. Investors are often disappointed by the poor returns generated out of these specialized firms. In fact, these firms flood the market during the periods of high IPO activity. Biotech investors need to understand why bullish IPO markets are dangerous and why inexperienced investors should avoid. Two key issues characterize the investments through IPOs: Exit strategy and window.

Though there are no different rules for evaluating biotech investments, three rules for screening biotech IPOs can be used. First, the best candidates are companies with profits, or at least predictable revenues based on some product on the market. Second, the next class of IPOs will be companies with at least one and preferably several drug candidates that have completed phase II or phase II clinical trials. Third, companies that don't fit either of the two preceding categories are

Snapshot

- To become a successful biotech investor, following the herd is not a right approach. Investors should develop knowledge about the industry and if possible segregate the industry into niche sectors and analyze them separately.
- The industry is characterized by rapid advancements. Following the advancements on a day-to-day basis may not be possible for all investors. Hence, investors should learn from the money managers, investment bankers and analysts, wherever possible.
- Investors should discriminate between hype and reality and should make investment decisions based on the knowledge developed about the industry.
- There are different types of tools that have to be used in evaluating investment decisions based on age, risk tolerance, knowledge of underlying science and familiarity with stock trading.

speculative plays, and while investors might make money buying and selling them during a bull market, the risk of getting stuck is high when the bull market ends.

The biotech toolmakers

In the process of exploring new frontiers in biotechnology, biotech scientists have invented a complete range of tools to probe and analyze molecular processes in detail. The research tools have laid the foundation for companies and these companies in turn have created new areas of investment in biotechnology. Biochips and biocomputing are the main categories of biotech tools. Both the categories result from the convergence of high-tech and biotech skills. Biochips allow drug-discovery researchers to perform more experiments in less time and enable them to study thousands of samples simultaneously, comparing healthy cells with diseased cells to look for patterns. Biotech firms have to depend on automated detectors that feed data directly to computational systems. The automated software systems have created their own niche market called bioinformatics.

In the process of exploring new frontiers in biotechnology, biotech scientists have invented a complete range of tools to probe and analyze molecular processes in detail

Since these companies can sell their products directly to the researchers at drug, biotech and university laboratories, without any formal approval from the FDA, they tend to start generating revenues much earlier than other biotech companies. Most of the biochip and bioinformatics companies are young firms with relatively small market caps. Investors who have the experience with high-tech stocks may feel comfortable taking positions in these companies. But for most investors this sector represents a chaotic arena in which risk outweighs opportunity.

There are so many companies focusing on specialized pieces of drug development and unless the investors have the special expertise in drug or computing technology, identifying the winning companies is a big task. Investors interested in this sector should look only at companies with revenues and strong revenue growth and some prospect of profits in one or two years.

Industrial biotechnology

Another frontier in biotechnology that is ever expanding is industrial biotechnology—the technology used to produce a wide variety of industrial chemicals and novel materials. This is not an entirely new field and hence we have a couple of established companies and new companies. Since there are promising players in this field there is a general excitement for investing in this sector. However, investors have to keep in mind two aspects: First, investors have to focus on product rather than the technique. Second, since low-cost manufacturers dominate the industry, only a handful of players may be possible.

Today, the drug and biotech companies use the same techniques to invent medicines, discover tools and new materials. Most of the firms find it necessary to form alliances with larger companies. The reason behind the formation of alliances is raising money. Investors need to analyze these alliances rather than assuming that since a big company has invested in a little outfit, they should also do it. The company's future depends to a large extent on the nature of the alliance it strikes.

The real problem is that it is difficult for the investors to learn about the nitty-gritties of the deals. This is especially true with early-stage research alliances. In spite of the odds, prudent investors don't act until they understand the details. Investors have to check the deal track record of the company either by going through their website or published reports. Then estimate how much revenue the company must be reporting annually. Compare these revenues with the company's quarterly or annual statements. Investors will be getting two rewards for such an analysis: First, they get a deflation factor for assessing any future deal announcement by the same company. Second, this also gives the picture of the management character. Until and unless the details of the deal are clear it is advised not to opt for such companies which promise but fail.

The investment frontier

No doubt, innovation will continue in each niche of biotechnology as scientists and financiers devise new ways to apply the fundamental tools. Along with the innovation in biotech, the investment trends will also undergo a change with time. The investment decisions have to be analyzed from three different viewpoints. First, rely on the advice, suggestions and rubrics of money managers, analysts and investment bankers who track the biotech shares on a daily basis and have the experience. Second, understand the tips, tricks and hard-earned lessons of the peers who have learned to tolerate its risks. Finally, it is important to consider one's own investment horizon as it is defined by their age and circumstances.

It takes patience, research and level-headed thinking to succeed as a biotech investor. By learning the lessons and adopting a systematic approach, the chances of succeeding or profiting from the surge in biomedical invention appears to be great. In fact, the biomedical innovation has been building for more than two decades and it appears that it has many more decades before it runs its course.

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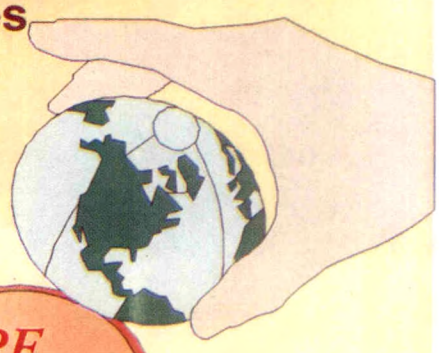

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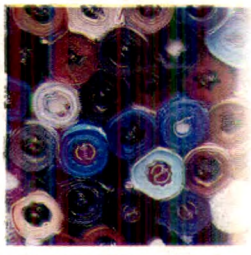

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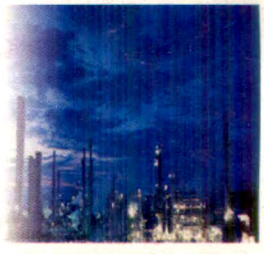

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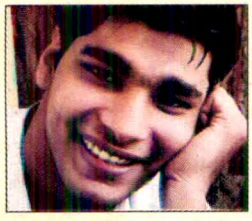

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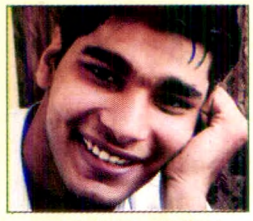

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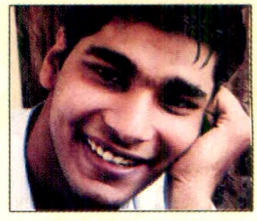

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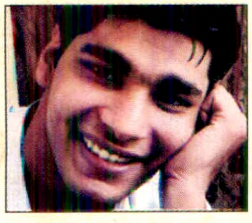

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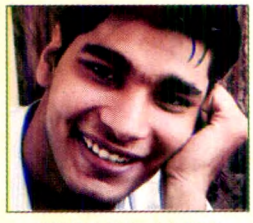

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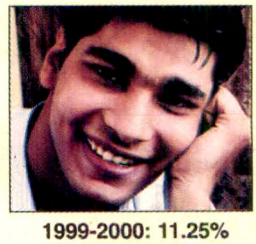

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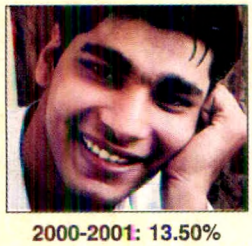

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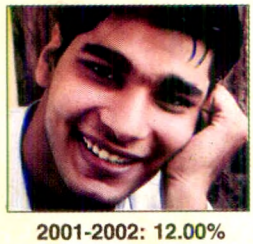

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1999-00	Rs.15.00* (Interim) Rs. 11.25 (Final)	208.71/Rs.100 168.19/Rs.100	29.3.2000 29.6.2000
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ISSN 0972-5053

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Printed and published by E N Murthy on behalf of The Institute of Chartered Financial Analysts of India, The ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh. Printed at M/s ICIT Software Center Pvt. Ltd. (Press Division), 3-112, Fatehnagar, Sanathnagar P.O., Hyderabad - 500018, Andhra Pradesh and published from The Institute of Chartered Financial Analysts of India, The ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh.
Editor: E N Murthy

Virus on the Prowl

As life slowly returns to normal in the SARS affected regions, the business community is busy studying the impact of the virus. SARS undoubtedly has made a dent in businesses across the world. China, Hong Kong, Singapore and Taiwan have lowered their growth forecasts. In fact, the growth forecasts have been downgraded for the entire South-East Asian region.

Tourism, which is one of the major forex for most of the countries, has been adversely affected. The number of tourists coming to South-East Asia has dropped by more than 85%. SARS has delivered a deathblow to the airline industry, which was recovering from the aftermath of the 9/11 disaster. Many flights have been grounded and the staff of major airlines were forced to go on unpaid leave. While the region as a whole experienced a demand shock, consumption and investments dropped. Hotels, restaurants, theaters, pubs and even shopping malls saw a drop in customers as people avoided crowded places.

April to May is an important season for finalizing export deals. With the SARS outbreak, deal making came to a grinding halt and this resulted in loss of opportunity. Some of the export orders have gone to the competitors in the Latin American region. The manufacturing industry for most part has not borne the brunt. Though the manufacturing firms have seen absenteeism, it was not large enough to disrupt the process and cause supply shocks. Though the regional players are hard hit, SARS is also having an impact on the global players as most of the big players see China as a growing market. Decreased consumption and spending is hitting the bottom line. Many American companies especially in the IT industry depend on this region for sourcing of their raw materials like chips and other hardware components.

SARS has also benefitted a few. Companies selling masks and disinfectants have seen a rise in sales. Sales of products and services that help people stay at home, like packed food, DVD etc., are doing roaring business. The share prices of pharma companies that have the potential to discover the vaccine against SARS have seen their share prices go up as shareholders expect a windfall.

The SARS epidemic has brought to light the vital responsibilities of governments in the wake of epidemics. China has been criticized for not doing enough to stop the spread of SARS and suppressing the figures of the number of patients affected by the virus. Even the WHO experts were not allowed into China till last month. This has forged a consensus in the diplomatic circles to allow undue access to WHO experts to enter countries, as in the case of nuclear and chemical weapons. This would go a long way in containing the spread of such deadly diseases thereby minimizing the economic impact.

Ch Rajeshwer

Letters to the Editor

Interesting Issue

I saw the article on Ahold in the latest issue of the *Analyst*. It looks good; in fact, the whole issue looks very interesting.

Prof. J Edward Ketz
MBA Faculty Director
Smeal College of Business
The Pennsylvania State University

Kudos *Analyst*

I read *Analyst* regularly and am happy to say that it is one of the best magazines right now.

Karan M
Karan_m82@sify.com

The Power of 'Oil'

The cover story on 'Oil' was very timely. Oil is one commodity, whose prices can wreck all economies. The political uncertainties in the oil-rich Gulf region create further price volatility. Now that the Iraq war is at an end, the receding prices are a welcome sign.

P Raghu Yadav
Patna

German Economy

The article on German Economy published in the May issue of the *Analyst* was very interesting and informative. The third largest economy of the world is suffering from myriads of problems. German economy is indeed in recession and the pressure on the leadership to act fast is high.

P S Sudha Swami
Coimbatore

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CHARTERED FINANCIAL
ANALYST

Cartoon Corner

YOU SAID IT by Laxman

Most intelligent secretary I've ever had! Along with my order he has already brought the order for its roll-back also!

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Verbatim

In the 16 years that I was the governor of the Central Bank of the Netherlands, there were two years in which we had deflation of 0.5%. I publicly declared then that I lived in a central banker's paradise.

– Wim Duisenberg, President, European Central Bank on declining economic fortunes of Eurozone

It is always difficult to calculate the impact of shocks on an economy, and especially external ones over which policymakers have little control. No proper assessment can be made until SARS has been brought firmly under control in all parts of Asia.

– The Economist magazine – SARS impact on South-East Asian countries

We believe the sanctions no longer make any sense and that they should be removed as soon as possible.

Gerhard Schröder, Germany's Chancellor on Iraq aftermath

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The SARS epidemic has not only managed to affect a handful of countries but is also threatening to affect the global economy. Many of the institutions have downgraded their growth forecasts due to SARS. Industries from tourism to information technology have all been affected. SARS also raised questions on the capability of countries to curb outbreaks. What is the global economic outlook? Who are the winners and who are the losers? What is the long-term impact of SARS and what are the lessons countries and the business world can learn from the SARS episode?

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Nasdaq: After the Tech-bubble

The decade of 1990s stands a witness to some of the highest points in stock markets world over but the downturn brings out a different story. The Nasdaq rose to prominence on the high tide of technology and telecommunications stocks. With the tech-bubble punctured, the stock exchange is struggling to keep itself afloat. It is hard to imagine that an exchange, which, barely three years ago was a roaring success, is in such a bad state today. Nasdaq's fond dreams of becoming a global exchange is a far cry from its present reality. The tech-ladden Nasdaq was destined to take a heavy beating in the downturn. As technology stocks lost their market capitalization, Nasdaq lost its attractiveness. The reasons for this situation are many.

The lackluster capital markets took their toll. Listing fees contribute to around 20% of Nasdaq's revenues and the number of companies that are either forced or chose to go for delisting has increased in the past couple of years. Nasdaq's rule that shares should have a minimum share price of $1 has only added to the exodus. This has raised concerns over liquidity and more players now prefer the NYSE. IPOs, yet another lucrative revenue source for Nasdaq, have also dried out considerably after the bubble. The ECNs (Electronic Communication Networks) are acting as the tough competitors, who are denting into the exchange's profitability.

In order to increase its competitive position, Nasdaq launched its Supermontage platform recently. But the delay in gaining SEC approval and the interference of ECNs has largely watered down the effectiveness of this new platform. Nasdaq's plans to go global have also been unsuccessful. Nasdaq Japan, its first initiative to expand globally did very poorly and the exchange had to close the venture and write off the investment. The poor market conditions and the troubles have closed the option of going for an IPO.

Nasdaq is trying to find its strengths and increase the chances of its survival. It has proposed a measure, which provides an option to listed firms that meet higher financial requirements to take an extended compliance period to satisfy minimum bid price requirements. There is also the primex proposal that seeks to bring some aspects of auction market mechanism to Nasdaq dealer-focused trading platform. This would provide investors with an opportunity to receive prices that may improve over the bid and offers displayed by the dealers. To what extent these efforts will succeed is a question only time will answer. But for now, the name Nasdaq has lost some of its erstwhile charm.

D G Prasuna

SARS Cascading Problems

The global economy witnessed the dreadful event of 9/11, after that the war on Iraq and now the SARS (Severe Acute Respiratory Syndrome), which not only hinders normal human life, but also causes difficulties in the areas of tourism, air travel, hotels, conventions as well as trade shows of the global economy. In other words, SARS is quite effectively shutting down Asia to any kind of people movement. The epidemic originated in Red China next to Hong Kong and has now spread to 25 countries. It has already infected on the global trading center of Hong Kong, the manufacturing powerhouse of southern China and the Canadian financial capital of Toronto.

We had the global pandemic of Hong Kong flu in 1968 and the swine flu fiasco of the mid-1970s. The world is long overdue for a major flu pandemic. If SARS spreads at the current rate then global manufacturing will simply grind to a halt. In a report released in April 2003, the World Bank lowered its growth forecast for Asia from 6 to 5%, which puts the cost of the SARS epidemic at roughly $30 bn, a tiny fraction of Asia's losses in 1998. The study attributed most of the losses to panic, not illness, noting, "in the short run, the economic consequences arise almost entirely from public perceptions and fears about the disease and from precautions the public is taking against it rather than from the disease itself."

Experts say that SARS epidemic could cause a trade war. Like it is helping to perpetuate the undervaluation of Asian currencies. That will negate many of the benefits for the US economy of a weaker dollar and prevent a much-needed major reduction in the US trade deficit, now running at an unsustainable $500 bn a year. Group of Seven Finance Ministers Meeting (May third week) in France should consider the yen and the yuan and related Asian currencies. Without revaluations, increased trade tensions are inevitable as exporting countries fight harder than ever for their share of what is likely to be a shrinking—US import market. Changes in relative currency values ought to be the principal means of reducing the US deficit. But the biggest trade imbalance is not with Europe or with America's NAFTA partners but with the Asian nations whose currencies continue to track the dollar. However, SARS makes Asian firms more aware of Business Continuity Planning (BCP), which allows companies to weather operational disruptions. BCP has become the buzzword and it has taken on a new dimension because of new concerns like SARS, whose economic impact on East Asia is like that of the repercussions of 9/11 attacks in US.

N Janardhan Rao

Challenging the Status Quo

Great ideas, or products for that matter, do not always make for great profits, once commented a management thinker. Look at the aviation industry. An aircraft is a great invention, however, the airlines world over, are not making great profits. In recent times, owing to the adverse business environment and, in some cases, their own inefficiencies, many airlines have gone bankrupt or are dangerously close to that. Another great discovery of the industrial era is the automobile. The big guns of the automobile industry, GM and Ford, who for long were praised for their great models and customer focus, too have found themselves in troubled waters of late, despite their massive scales of operation and global reach, in addition to their financial muscle. Unfortunately, that has not come to their rescue as business rules have consistently been rewritten by nimble competitors like Toyota, Honda and Hyundai on the backed by design and product innovation; Hyundai, in fact, has shaken the competition with its sleek, fuel-efficient small cars.

Is it that small is beautiful in the world of automobiles? Perhaps! as exemplified by the likes of Hyundai. However, more than size, it is the ability to adapt itself to the changing business environment and customer preferences that have kept Hyundai in full swing. However, there are companies like Fiat, that has been in trouble for a long time now, and has failed to keep pace with changing times. The question is what prevented Fiat from attuning itself to the changing customers' preferences. Maybe, it lacked the vision and leadership required to sail against the odds. It remained a strongly guarded family-run company even when the trend was towards professionalism. Another lesson from the company is that it ignored the reality—when the companies need to go global if they have to grow big and survive competition from multinational companies, Fiat chose to remain confined to Italy. And, when it took its globalization gambit it was too late. Its experiences in various countries were bitter for different reasons. It had to make a hasty retreat from the American markets due to heavy competition from nimble players. Its efforts in Brazil, Poland, Turkey and Argentina too proved unfruitful. Fiat blames the harsh economic conditions in these regions but they failed to understand the competition and customers' preferences. However, all may not be lost for Fiat. The bottom line is – there is no way a company can survive unless it is willing to adapt to the changing business environment and perhaps more importantly challenge the status quo, i.e., innovate.

Amit Singh Sisodiya

Rescuing Underwater ESOPs

Employee Stock Options (ESOPs), once the favored form of compensation are now increasingly under spotlight. To begin with, the accounting treatment of stock options and the argument for expensing them is gaining momentum. While the finer points are yet to be finalized, there seems to be a general agreement among regulators and standard-setting bodies towards expensing them. The other contentious issue with regard to ESOPs is repricing underwater stock options.

The boom of 1990s saw a surge in ESOPs. In the race to attract and retain talented employees at the height of the technology bubble, most new economy companies relied heavily on ESOPs. The meltdown of the stock bubble brought to fore an unforeseen problem. ESOPs issued at the stock market highs lost their entire luster and attractiveness as incentives once the stock prices tumbled down. With strike prices higher than their current market prices, most ESOPs virtually turned useless as incentives. The way out: Repricing. Companies that are opting for repricing stick to the old line of argument retaining key employees. Research proves that use of ESOPs does minimize employee turnover and thus the costs to the organization. In the knowledge-driven economy employees are the key assets who determine the fortunes of the organization. So, finally the shareholders may stand to gain with improved performance and increased wealth creation.

The argument does hold good but one has to consider how shareholders (who have no such repricing option for their shares or stock options) perceive this measure. Whether shareholders would support repricing of ESOPs is an important issue for companies that are considering repricing. With increased pressure to seek shareholder's approval for any kind of stock-based compensation, they could have the final say on reprcing.

There are other fundamental issues. Repricing of ESOPs defeats the basic logic of aligning employees' interests with those of shareholders'. ESOPs have been considered as a means to align the interests of employees with those of the shareholders. But if employees are convinced that every time the market price falls, their stock options would be repriced, where is the issue of alignment of interests? This creates a moral hazard since employees have nothing to lose even if the stock price falls. The accounting treatment of repricing is yet another issue that needs to be resolved. The bitter experiences of the post-bubble era have eroded investor confidence. ESOPs are viewed with disfavor by shareholders thus forcing companies to search for alternative forms of compensation.

D G Prasuna

Inflation rate to turn soft

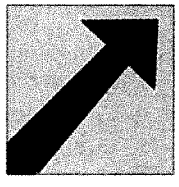
RBI Governor Bimal Jalan ruled out the possibility of a change in Repo rate, but hoped that inflation would turn soft from the second quarter of the current fiscal. "We maintain the same position that Repo rate is flexible, but there is no proposal right now to change it from 5%," says Jalan. Repo rate is the rate at which RBI borrows overnight funds from banks. The current rate at which the apex bank borrows is 5%. There was apprehension in the market that considering the existing liquidity in the market, rates might be changed. The RBI governor opines that "we are hoping that with oil prices now having come down quite substantially since the Iraq days and hopefully if the monsoons turns out to be good or 96%... what is being predicted now, we should see a softening of edible oil prices also." The governor reiterated that credit off take had improved in the last few months and industry was witnessing some upturn, which was reflected in the latest IIP.

Taking on the dragon

India's exports during the current year have increased over 20% which is certainly a good news for the country. However, whether this growth is sustainable or not remains a puzzle. This year (April-December 2002) exports to China increased to $1,260 mn. Hong Kong's share stands lower at $1,643 mn. This is still more than India's export figures for mainland China. While growth to China has been strong, when we combine the figures for Hong Kong and China, export growth has been much more moderate at 14% in 2000-01 and a decline of nearly 5% in 2001-02. This year imports from China and Hong Kong grew at 38.6%, faster than the growth of Indian exports. Interestingly, the balance of trade has been in India's favor as its exports to China and Hong Kong in April-December 2001 stood at $2,345 mn, while imports to them were $1,972 mn.

On the other hand, imports from China as well as from Hong Kong were dominated by imports of electronics. In 2001-02 India exported manufactured goods worth $2,298 mn to Hong Kong and $463 mn to China. The main cause of concern for the last three years has been that the share of value-added goods in the basket of India's exports to China remains low.

Output on the rise



India's industrial output rose 5.8% in the year 2003 till March attributed by a robust manufacturing sector despite fears that the country's worst drought in 15 years would hurt demand in Asia's third-largest economy. Data released by the government's Central Statistical Organization (CSO) showed output was up from a meagre 2.7% in the previous year when a global and domestic slowdown hit demand. Industrial output has been maintaining a steady pace in the past few months, rising 5% in December and 6.4% in January and February 2003. Output rose 6% in March 2003 compared to 3.2% in the same month a year ago. Manufacturing, which accounts for about 80% of industrial output, jumped 6% in 2002-03 compared to a paltry 2.9% in the same period a year earlier. It rose 6.8% in March 2003 compared to 3.2% in the same month a year ago. However, the Indian economy is estimated to grow at 4.4% in 2002-03, down from 5.6% in the previous year because of a slump in farm output. Nearly 70% of India's more than one billion people depend on agriculture for a living.

Merger norms

The market watchdog, the Securities and Exchange Board of India (Sebi) has made it mandatory for companies to seek approval from stock exchanges before filing schemes for merger, restructuring or reduction of capital before high court. In a circular, the regulator has asked the bourses to amend the listing agreement regarding disclosure pertaining to schemes of arrangement for merger amalgamation or reconstruction filed before the court. Sebi said in clause 24 of the listing agreement, three new sub-clauses should be added which makes it mandatory for company to agree that "it shall file any scheme/petition proposed to be filed before any court or tribunal under sections 391, 394 and 101 of the Companies Act, 1956, with the stock exchange, for approval, at least a month before it is presented to the court or tribunal." Thus, it would now require companies to file the scheme with exchanges one month before filing with high court for approvals of such schemes. Market pundits believe that this requirement will prevent several malpractices in the market including back-listing, delisting of securities without following rules laid down by Sebi.

INTERNATIONAL

Deflation fears

The prospect of falling prices sure sounds like a good thing. But a prolonged and widespread decline would spell disaster for the world economy. The International Monetary Fund (IMF) warned that Germany is at high risk of deflation and Japan, Hong Kong and Taiwan are vulnerable to an accelerating pace of price declines. The IMF report found a low chance of deflation in the United States, but added that there are "considerable uncertainties" in that outlook. "There has been a clear increase in the vulnerability to deflation for a number of industrial and emerging market economies," the IMF observes. The study, put together by a special task force overseen by IMF Chief Economist Kenneth Rogoff, comes at a time of increased worries about deflation around the world.

The US Federal Reserve has recently raised concerns about deflation in the United States and fears about deflation in Germany's stagnant economy have been on the rise. The IMF report warned that deflation, defined as a sustained decline in an aggregate measure of prices, is seldom benign and is difficult to anticipate. There is a 'considerable' probability Germany will face deflation over the next year if economic growth meets projections of 0.5% this year, according to the IMF.

'Now or never'

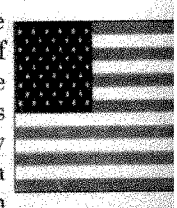
British Chancellor of the Exchequer Gordon Brown will announce the results of the Treasury's five economic tests that will determine whether Britain adopts the euro on June 9, 2003. The government set out the tests in October 1997 to determine a "clear and unambiguous" answer to the issue. The tests consider the British economy's convergence with the eurozone and the effect of joining on Britain's economic flexibility, foreign investment, financial services industry and growth. As a result, some economists have argued that Brown can say the economy has failed or passed some or all of the tests at any moment he chooses. One of the consequences is that Britain obviously will go its own way. "Economic decisions could get taken without considering the interests of the UK. It will mean that Britain will lose out economically, not by tomorrow morning, but in the long-term," opines an expert on eurozone. Making an economic assessment of the long-term effects is extremely difficult due to the many uncertainties. As a result, there is not going to be a "clear and unambiguous" answer when the government's assessment is announced.

Concern for Hedge Funds

The head of the Securities and Exchange Commission (SEC) reiterated concern about hedge funds, traditionally an investment outlet for the wealthy that are increasingly luring small investors. The SEC has been investigating hedge funds since last spring after seeing an increase in fraud among the high-risk funds. The agency has brought several enforcement cases along that line in recent years. The SEC also issued an "investor alert" in February 2003 advising investors to check out the background of hedge fund managers as well as the fees charged by funds. Like mutual funds, the speculative hedge funds pool investors' money and invest it in various ways in an effort to get the highest return possible. But unlike mutual funds, they mostly are not registered with the SEC and therefore subject to few controls. Investors in hedge funds don't receive the full protection. About 5,700 hedge funds operate in the United States with some $600 bn under management.

To attract smaller investors, funds of hedge funds—which invest in several hedge funds rather than individual securities—have sprung up recently and offered lower minimum entry requirements than traditional hedge funds such as $25,000 compared with $1 mn.

Bankruptcies on record high



According to the court officials of the US, the country's bankruptcy filings rose to a record high in the 12-month period ending March 31. Bankruptcies rose to 1.61 million from 1.5 million in the 12-month period ended March 2002, the Administrative Office for the US Courts said in a release. The number of bankruptcies in the first quarter rose to 412,968, up 4.5% from the previous quarter. The quarterly figure is the highest in the last nine years. A spokeswoman for the court opines that she believes the number is the highest since the courts have been collecting the data. Personal filings rose while business filings fell. Business filings were down by 5.8% in the 12-month period to 37,548.

N Janardhan Ra

Merger Street

Bertelsmann sells publishing arm

BERTELSMANN
media worldwide

Bertelsmann, the internationally reputed media and entertainment company, is selling its specialist publishing group BertelsmannSpringer to the private equity firms Cinven and Candover. Bertelsmann, Cinven and Candover signed a contract to this effect recently. The deal values the publishing arm at €1.05 bn. Through this transaction, Candover and Cinven are acquiring one of the world's most prestigious publishing groups for scientific and academic literature. The 70 companies that comprise BertelsmannSpringer publish 700 magazines and more than 4,000 new book releases in the fields of science, medicine, economics, engineering, architecture, construction and transport each year.

In 2002, BertelsmannSpringer generated total revenues of €731 mn and operating EBITA of €71 mn. The group has operations in 16 countries, with over 5,000 employees. The transaction is subject to antitrust approval. It remains to be decided whether Candover and Cinven will acquire BertelsmannSpringer's activities in France, which account for 4.5% of total revenues. The sale is in tune with the strategy of Bertelsmann to concentrate on core businesses. BertelsmannSpringer includes publishing companies such as the Springer science publishing company, Birkhäuser, Ärzte Zeitung, Princeton Architectural, Key Curriculum, Platow, Gabler, Bauverlag, Heinrich Vogel as well as a number of online services and the electronic service SpringerLink. In 2002, BertelsmannSpringer contributed 3.9% of Bertelsmann's total revenues.

Cinven and Candover are two of Europe's leading private equity companies. Cinven was founded in 1977 and has carried out over €40 bn in corporate acquisitions to date. Candover was founded in 1980.

Its transactions to date have a total volume of more than €22 bn. Candover has been traded on the London Stock Exchange since 1984. In January 2003, Candover and Cinven acquired the specialist information group Kluwer Academic Publishers from the Dutch information group Wolters Kluwer.

Sale of Northumbrian Water

Suez, the French utilities group, has agreed to sell Northumbrian Water to a consortium of international investors led by Deutsche Bank and Ecofin, the investment management group. Northumbrian Water, one of Britain's biggest water companies, is sold in a deal worth €3.1 bn (£2.19 bn). The company, under a financial restructuring, will be funded 80% by debt and 20% by equity. Suez will retain 25% of the shares, with the remaining 75% sold to institutional investors. The sale of shares was organized by the third member of the consortium, UK broker Collins Stewart, for €1.3 bn. The new owner will seek an immediate listing on Aim until it can arrange a full listing on the London Stock Exchange.The total value of the deal to Suez, needs to reduce debt, is €3.1 bn, after including €1.8 bn of borrowings at Northumbrian.

As per company sources, the deal along with other disposals of Suez would help it cut borrowings by €5.4 bn. Further, it would cut immediate borrowings and remove the burden of having to raise future debt to pay for large investment programs required by the European Union and British Government. Two other bidders, CVC Capital Partners, a private equity group, and Morgan Stanley Capital Partners, the investment bank's private equity firm, were also shortlisted. Morgan Stanley, the investment bank, advised the French conglomerate.

Real Estate Trust merger

Pennsylvania Real Estate Investment Trust (PR) has entered into a definitive merger agreement with Crown American Realty Trust (CA). The stock swap transaction is valued at $456.24 mn and the agreement includes the assumption of liabilities worth $619.1 mn. According to the agreement, PR will issue to Crown shareholders 0.3589 PREIT common shares for each outstanding share of Crown in a tax-free, share-for-share transaction.

Companies claim that the merger will position PR as a leading shopping mall REIT in the Mid-Atlantic region. The boards of trustees of PR and Crown have unanimously approved the merger.

The transaction includes a $20 mn termination fee payable to either PR or Crown if the merger is not completed in certain specified circumstances. PR will expand its board of trustees by two members, Mark Pasquerilla, Crown's Chairman and Chief Executive Officer, and another member of Crown's current board of trustees to be selected by PR.

Lehman Brothers and Citigroup advised PR while Crown was advised by Wachovia Securities Inc.

S&P's forecast

Standard & Poor's forecasts an increase in merger and acquisition activity in European insurance markets. While confessing that big ticket M&A transactions were conspicuous by their absence in recent years, the agency foresees a rise in the future due to the better economic and capital market conditions. Insurers' participation in M&A deals is expected to be slow and limited to opportunistic acquisition, with the aggressive expansionism of the late 1990s tempered by caution. S&P said the recent lack of capacity to finance M&A was compounded by the reluctance of insurers to take on acquisition risk. As conditions improved, future M&A activity was likely to be more intermittent than previously, with many insurance groups rediscovering the value of organic growth over growth by acquisition. The recent fall in M&A activity on the part of potential acquirers reflects the need for retrenchment following the exuberant activity of the 1990s, when expansionist insurers paid top prices to acquire new brands, distribution, and incremental market share. Groups that previously sought global status now conceded they could still aspire to be a large multinational without being in many of the world's more local regional markets.

Gold companies merge

AngloGold and Ashanti Goldfields are talking merger, which if consummated, would create the world's largest gold producer as measured by capacity.

AngloGold, South Africa's largest gold miner and currently the world's second-largest, confirmed its board was in talks with that of Ghanaian Ashanti on a proposed merger at a ratio of 26 AngloGold shares for every 100 Ashanti ordinary shares or global depositary securities. If completed, the merger would give the companies combined capacity of some 7.3 m oz, putting them on par or slightly ahead of America's Newmont Mining, which expects to produce between 7.1 and 7.3 m oz this year. The two African companies already operate a 50:50 joint venture at Tanzania's Geita mine.

A deal would allow AngloGold to diversify away from deep-level mining and South African exposure. AngloGold had been in the market for a partner since last year, when it lost a long and bruising battle for control of Australia's Normandy Mining to Newmont. Ghana's government also has the right to veto the disposal of assets via its ownership of a 'golden share' of the miner.

European brewers merge

Scottish & Newcastle

Scottish & Newcastle Plc. (S&N) has entered into a binding agreement to acquire full control of Sociedade Central de Cervejas (Cervejas), the Portuguese brewer and distributor, in which S&N currently has a 49% stake. S&N has acquired the remaining 51% stake in the business from its joint venture partners. In addition, S&N has entered into a binding agreement to acquire from the same joint venture partners, 100% of Sociedade da Agua de Luso (Luso), a leading producer of branded mineral and spring water, including the brand Luso, the number one bottled water brand in Portugal. The total cash consideration of these deals is €342 mn. S&N will also consolidate approximately €157 mn of debt relating to the two businesses (although €70 mn of this relates to S&N's existing 49% investment).

The combined net assets (in relation to 100% of Central de Cervejas and 100% of Luso) as at December 31, 2002 were €234 mn. The combined pre-tax profits in relation to 100% of Central de Cervejas and 100% of Luso for the year to December 31, 2002 were €37 mn (excluding exceptional costs and amortization).

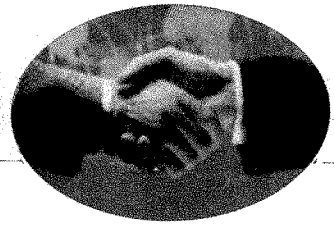
The transaction i expected to be earning enhancing in its first 1 months of ownership. Th acquisitions, which ar subject to the approval of th European Competitio Authorities, are expected t be complete by June 2003.

Alcatel acquire Timetra Networks

Alcatel, the French network equipment group has announced plans to acquire Timetr Networks in an all-stoc deal valuing the Silico Valley Internet route specialist at $150 mn. Th deal is Alcatel's biggest sinc its costly acquisition spre at the height of the bul market three years ago. I underlines the Frenc group's confidence that th worst of its financial crisis i behind it after cutting ne debt below zero last year an selling its cash-drainin optronics unit recently Alcatel hopes that Timetr would propel its Interne router activities to compet seriously with the likes o Cisco Systems and Junipe Networks, the marke leaders. The acquisition i expected to be complete b the third quarter. Th privately held Timetr which employs about 10 people would be integrate into Alcatel's US operations.

D G Prasuna

Deal Corner



Unlike global M&A activity that slowed down marred by Iraq war and SARS, M&As in India continued unabated. Though the current situation may affect the level of foreign investment into India, consolidations and restructuring within the country are expected to continue.

Trends in M&A deals

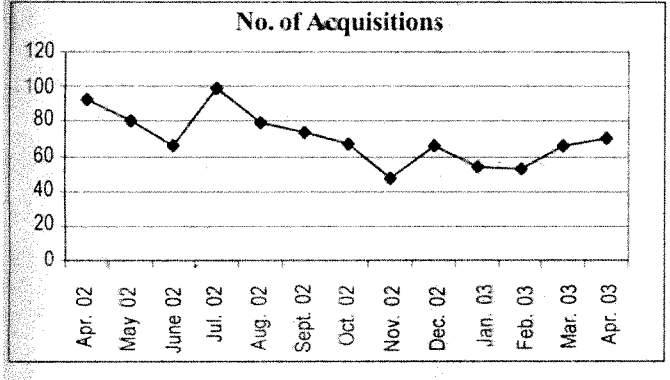
Eighty-three M&As aggregating Rs. 1,150 cr were announced in the first month of the new fiscal i.e., April 2003. While number of acquisitions increased by 6% to 70, mergers dropped to 13 from 35 deals recorded in March 2003. Average value per deal decreased by 37%. On a YoY basis, the average value per acquisition deal plummeted to Rs. 16.43 cr compared to Rs. 19.38 cr per deal recorded during April 2002. The main sectors of consolidation during April 2003 were the Food and Beverage (F&B) sector, the chemicals industry and the transportation and communication service industry. F&B sector has seen a steady stream of M&A deals during the past two years. During the period, this sector has witnessed 51 acquisitions and 25 mergers. While tea and coffee industry has seen a decline in consolidation activity, chemical industry represents another sector witnessing hectic consolidation. During the 12-month period May 2002-April 2003, 157 M&As aggregating Rs. 6,171 cr, double the amount recorded during May 2001-April 2002 period. However, proportion of M&As in the drugs and pharmaceuticals industry to chemicals industry has seen a massive drop during the past 12 months. Though transportation and communication services industry has always been an area of high-value M&A deals, the proportion of these deals in total M&A activity has been on the decline in April 2003.

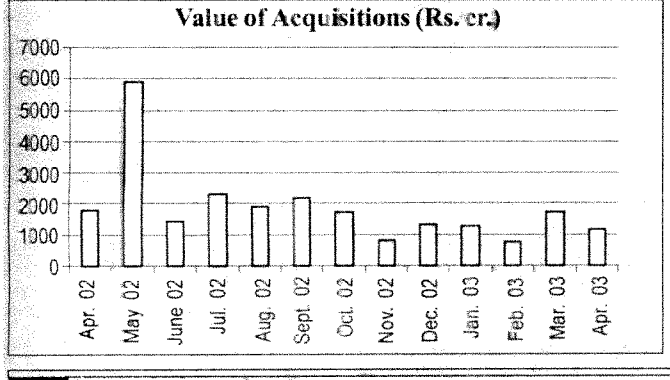
Month	Industry*	No. of Deals	Corresponding Value (in cr.)
Apr. 02	Chemicals	15	334
May 02	Chemicals	11	2,860
Jun. 02	Chemicals	9	186
	Financial Services	9	369
Jul. 02	Electronics	20	89
Aug. 02	Electronics	13	977
Sep. 02	Chemicals	13	279
Oct. 02	Chemicals	14	274
	Chemicals and Plastics	14	274
Nov. 02	Electronics	11	48
Dec. 02	Financial Services	8	54
Jan. 03	Financial Services	7	135
Feb. 03	Electronics	15	73
Mar. 03	Financial Services	13	300
Apr. 03	Chemicals	15	577
	Chemicals and Plastics	15	577

*Month-wise topper in terms of number of acquisitions.

Month	Industry*	Value (in cr.)	Corresponding No. of Deals
Apr. 02	Non-ferrous Metals	475	3
May 02	Chemicals	2860	11
Jun. 02	Electricity	481	4
Jul. 02	Financial Services	265	10
Aug. 02	Electronics	977	13
Sep. 02	Financial Services	1320	4
Oct. 02	Diversified	945	1
Nov. 02	Chemicals and Plastics	319	7
Dec. 02	Electricity	743	1
Jan. 03	Transport and Communication Services	367	6
Feb. 03	Financial Sevices	182	6
Mar. 03	Chemicals	992	9
Apr. 03	Chemicals	577	15
	Chemicals and Plastics	577	15

*Month-wise topper in terms of value of acquisitions.

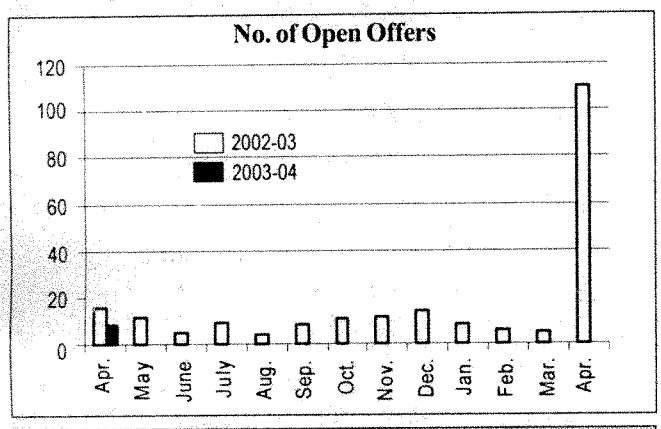


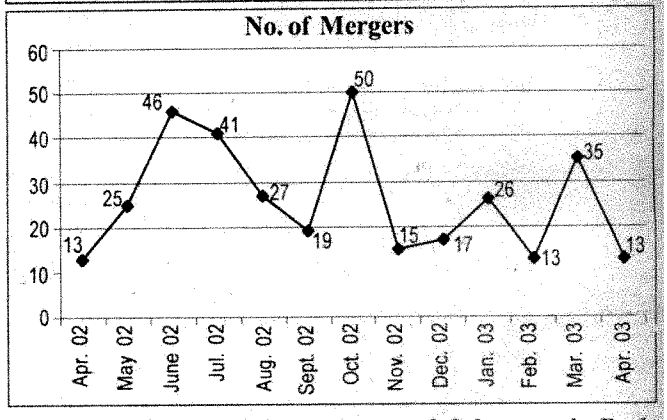


Open offers

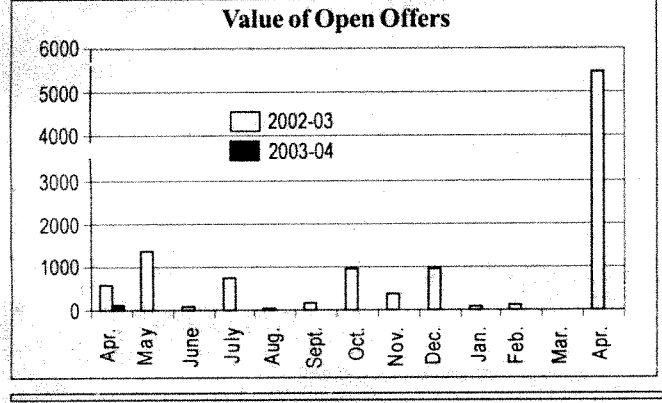
Eight open offers worth Rs. 90.94 cr were announced in April 2003. Coupled with revisions of earlier open offers, total offers amount to Rs. 124.9 cr. In a marked departure from earlier months, seven of the eight offers were the result of changes in management control. The open offer of Colour-Chem for 20% stake was finally announced on April 7, 2003 after five years, with reference date of November 21, 1997 for calculation of offer price, at a price of Rs. 381 per share. This also triggered open offer in Vanavill Dyes & Chemicals, a subsidiary of Colour-Chem. Other companies that made open offers include, Ahmedabad Victoria Iron Works Co. aimed at delisting, Welcast Steels for 20.04% stake, Akhileswar Texports for 10.30% and Schenectady-Beck India aimed at delisting.

Value of Open Offers (Rs. cr)					
Month	1999-00	2000-01	2001-02	2002-03	2003-04
April	9.5	38.2	112.6	595.5	124.9
May	138.3	660.8	351.9	1377	
June	11.1	0.6	72.4	76.1	
July	50.4	58.6	63.1	725.4	
August	4.4	2	335.4	23.8	
September	14.6	22.3	205.1	147.4	
October	14.6	199.9	110.3	964.1	
November	47.7	43.2	128.2	381.8	
December	138.1	1047.4	963.6	954.8	
January	38.9	18.7	66.2	66.6	
February	8.5	46.6	1855.6	130.1	
March	276.2	487.3	526.5	20.4	
Total	752.3	2625.6	4790.8	5464.7	





No. of Open Offers					
	1999-00	2000-01	2001-02	2002-03	2003-04
April	10	6	6	16	8
May	7	9	7	12	
June	2	2	4	5	
July	4	2	10	9	
Aug.	4	6	10	4	
Sep.	3	6	7	8	
Oct.	6	10	5	11	
Nov.	5	2	10	12	
Dec.	18	10	10	14	
Jan.	6	5	10	8	
Feb.	13	3	10	6	
March	11	15	10	5	
Total	89	76	99	110	



Substantial acquisitions of equity stakes in companies

The Board of Centurion Bank accepted the offer by Sabre Capital Worldwide Inc., that entails the bank to infuse Rs. 219 cr which would raise Tier I capital of bank improving its CAR. The structure of the deal requires high court sanction under Companies Act and SEBI may ask the bank to make open offer, as the management control will be shifted in favor of Sabre Capital. On the other hand, UB group that holds 65% stake in Associated Breweries & Distilleries will soon convert it into a wholly-owned subsidiary. In another important development, FIPB has rejected Bharati Global's proposal to acquire shares of Bharati Televentures from the secondary market.

Disinvestments

Reconsidering privatization of Shipping Corpn of India, Government will now permit foreign participation without any ceiling. Fresh EOIs will be invited for divesting 51% stake. Central Government has approved Larsen & Toubro's bid for control valves business of Instrumentation Control Valves. On the other hand, Maharashtra State Government is disinvesting 100% stake in Chitali Distillery.

A Sowdeepti

HP-COMPAQ

A year into merger

Thanks to meticulous integration efforts, the year old HP-Compaq marriage is showing signs of success, most critics have muted their opinions. A few, though, are still not convinced.

When the Palo Alto giant and the Houston major decided to merge in 2001, critics argued that while the two companies would be preoccupied in integration, their competitors would gain useful time to outpace them in the fast changing information technology industry. They contended that the main beneficiaries of mergers in the computer industry, as suggested by its history, have been competitors, because companies become so focused on organizational matters that they lose sight of their customers. Then they said that most of HP's and Compaq's revenues are generated from the sales of relatively similar servers and PCs. And once the two companies merge their operations and eliminate overlapping products, they are likely to alienate and lose customers they hope to gain through the deal. They also felt that both the companies' culture would hinder the integration process. But, now, against all odds, the company seems to be proving all those people, who said that the marriage of HP-Compaq wouldn't work, wrong.

HP vs. IBM and HP vs. Dell

In contrast to critics' beliefs, Fiorina foresaw greater scale in PCs, and a greater emphasis on services as an ideal response to commoditization of the PC and the increasing importance of IT consulting services. She believed that the merger would let HP exploit economies of scale in PCs and enable it compete more effectively with Dell. At the same time the merger would strengthen HP's services arm, so that it can take on IBM. She even promised better market coverage, considerable synergies and increased profits than either company would achieve on its own.

Today, slowly but surely, Fiorina's promises are being fulfilled. HP outpaced Dell in the PC market in the last three months of 2002, according to the research firm, International Data Corporation (IDC). HP's PC division is back to its profit making days. On the other hand, HP has surpassed IBM to grab the lucrative $3 bn services contract from Procter & Gamble. Both the companies have worked out an agreement in principle to a $3 bn, 10-year Information Technology (IT) managed services contract. Besides, HP has entered into a $600 mn services contract with the Bank of Ireland and an agreement worth $1 bn with Ericsson.

Even the cost front is robust. Fiorina promised cost-cutting to the tune of $2.5 bn by October 2003 and in all possibility, that figure would be a much bigger one around $3 bn.

Those rosy numbers were largely a result of a meticulous integration exercise that helped both the companies avoid the mistakes of their previous merger glitches. The companies had a detailed integration plan in place when they announced their merger plans. But in view of their merger histories [HP's Verifone, Apollo and Compaq's Tandem and Digital Equipment Company (DEC)], critics were reluctant to buy their argument. Then again, their merger record might have taught them some valuable lessons and it was made sure that this integration doesn't prove to be as sour as their previous ones.

Finding success in details

Even though M&A is the common way of doing business these days, studies reveal that as many as 75-85% of M&A attempts proved unsuccessful. Such a high rate of failure can be attributed to the difficulties associated with integrating companies with very different corporate cultures. Skeptics of the HP Compaq were very apprehensive about blending the companies' culture. They reckoned that while the HP culture is a more professional, solution-driven, partner-driven one, Compaq's is an arrogant, driven mostly by market share. The integration teams focus on strategy, process and people. And though they serve as vehicles for realizing the synergies of the merged companies, cultural differences can jeopardize the process. However, too much focus on culture can be more of a distraction and significantly slowdown the integration. So, HP followed the 'cultural due diligence', which focused on identifying cultural differences. To do that the human resources staff interviewed 150 senior executives and arranged 35 focus groups for employees. And surprisingly they discovered that the two firms were not that distinct culturally, especially when the divisions that operate in the same markets were compared.

With cultural issues at bay, the duo went ahead with its integration plan. As lack of proper planning was the principle cause of the initial hiccups with the merger of Compaq and DEC, about half a million man-hours of work were devoted to integration planning this time

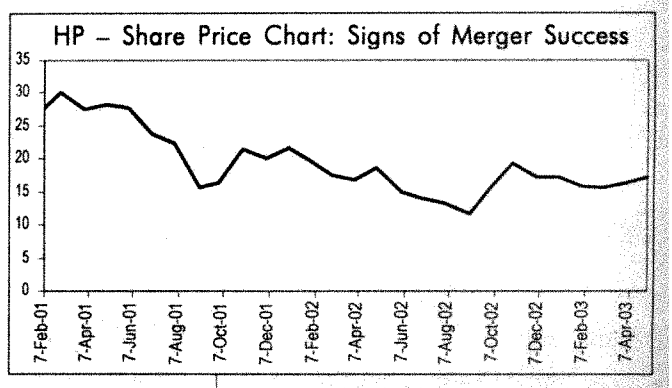
around. While the integration process for Compaq and Digital started quite late and was leaderless for a long time, discussions on how to integrate HP and Compaq began way before the bankers were called and one of the first decisions taken by the combine was to name the executives who would lead the business units of the merged entity so that they could be involved in planning.

HP and Compaq also created an integration office swiftly. In fact they called it internally as the 'clean team' as it was to remain separated from other employees as long as the two companies were rivals. This group, with around 600 full-time members, formed the core of the merged company. The four main business units had their own working groups and other teams dealt with issues like IT systems, finance and human resources. Specific teams had been given the mandate of ensuring that 'value capture' is done appropriately, which means that these teams have to make sure that the promised annual cost savings of $2.5 bn are achieved by 2004.

All the working groups were provided with clear, precise goals and guidelines on how to work, to ensure that decisions are made quickly and the groups stick to them, so that the execution process is smoothened. The objective of such moves was to avoid conflicts among the groups. In cases where there was a disagreement between groups, the help of consultants were sought. And, where difficult decisions, such as the organization of the supply chain, product decisions, organization of the salesforce, were involved, the 'steering committee', consisting of the top executives who met every week, was roped in.

So far so good, yet so far...

The integration efforts are gradually paying off and the new HP has edged out rivals IBM and Dell, at least for the time being. But the future is still a bit murky. The PC business is still stagnant. Even rival Dell is moving away from PCs. It has entered HP's by getting into printer business, and is even considering a name change to reflect its expanded product portfolio or rather to move away from its 'PC' image. (It wants to drop 'computer' from its name, Dell Computer.)



The problem is that the new HP, like the old one, still depends largely on its printing business. "Currently, much of its profitability is from the printers (and related products) business; in the absence of killer products in its other businesses, HP could be very vulnerable to a downturn in the fortune of the printer business," says Rishikesh T Krishnan of IIM-Bangalore.

Then again as the benefit of cost-cutting and synergies, which is what it was focused largely on till now, wane of, the focus will shift towards market share. The new HP continues to be sandwiched between IBM and Dell and it will take a lot of time for HP to topple these entrenched players from their tightly held positions. A more serious concern, says Krishnan is that some cost saving has come from cutting down on long-term R&D projects. And in this context he says, "it is worthwhile to note that the printer business is what it is today. Thanks to large investments in product development and innovation over the last decade."

It is lonely at the top

Another concern is regarding the leadership. Capellas' departure, to turnaround the bankrupt WorldCom, has raised eyebrows over the future potential for success of the company. Fiorina has always been a marketer—she sold the deal to skeptical investors, employees, and customers of both companies. Capellas on the other hand is a true techie, an operations person. He clearly understands technology. He seems to be behind HP's significant strategic moves till now. HP's reorientation towards Microsoft and windows even as IBM is moving towards Linux, thereby offering buyers a distinct alternative, appears to be Capellas' idea rather than Fiorina's. As *Fortune* says, "Capellas, who has been talking about the importance of industry-standard computing for years, seemed to be more a driver of that strategy than Fiorina."

But, with Capellas' departure, HP might have lost that techie touch. However hard she may try, Fiorina will remain a marketer and ironically, HP might need a techie now to reinvigorate its innovative spirit and boost its R&D efforts. On one hand the company has a tag line that says, 'Invent' and on the other it is axing its R&D, putting its future in peril.

Also, while many eminent experts suggest that it would be logical for HP to tie-up with Microsoft, the company, these days is riding the Linux bandwagon and emulating its rivals.

As the concerns because of Capellas' departure ease out, Fiorina, alone at the helm of affairs, has to put her best foot forward and show her dare devilry in taking the company successfully into the future.

CSV Ratna

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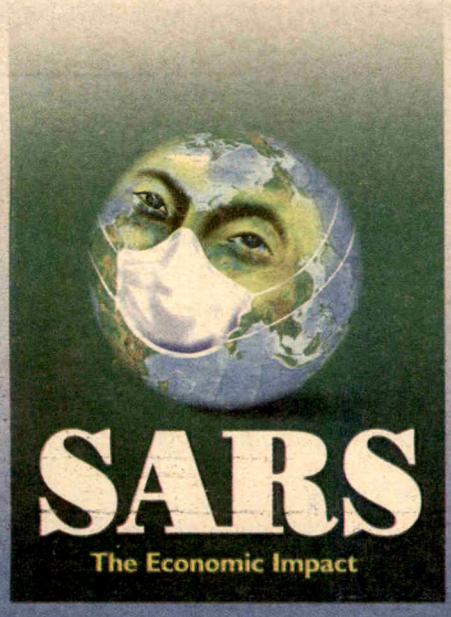


The SARS epidemic has not only managed to affect a handful of countries but is also threatening to affect the global economy. Many of the institutions have downgraded their growth forecasts due to SARS. Industries from tourism to information technology have all been affected. SARS also raised questions on the capability of countries to curb outbreaks. What is the global economic outlook? Who are the winners and who are the losers? What is the long-term impact of SARS and what are the lessons countries and the business world can learn from the SARS episode?

SARS

The Economic Impact

The 9/11 disaster, the war on Afghanistan and Iraq and just when the world thought that it had enough, the news of the deadly epidemic of SARS (Severe Acute Respiratory Syndrome) is catching the attention of one and all. These events are anything but dashing the hopes of revival of the world economy already reeling under severe downturn. While the economic impact of 9/11 and the war is severe and having global repercussion, the fallout of the SARS epidemic though seen more as a regional problem is also in its own way plaguing the world economy.

SARS though first reported in the Chinese Guandong province six months ago, really came into the spotlight in the month of April. While SARS has taken more than 600 lives and infected more than 8,000 people, it has caused inconvenience to millions of people and affected directly or indirectly various business interests all around the world. It also managed to make a dent in the economic growth of some of the worst affected countries.

The countries directly bearing the brunt of SARS are China and Hong Kong. Other countries like Singapore, Taiwan and Canada also have felt the effect of SARS. In China the domestic consumption and exports both seemed to be the hard hit. Even though these vital indicators can be reversed once SARS is brought under control, the greater issue which can have quite a lasting impact seems to be the secrecy and lack of transparency on the part of the Chinese to part with information. Such behavior creates doubts

in the minds of the investors. It will be some time before potential investors overcome their fears and regain faith and get going with tapping this huge potential market. However, this does mean postponement of any growth prospects such investors may have visualized in the short-term.

SARS came at a time when Hong Kong was mired in problems. The Special Administrative Region (SAR) was already reeling from the deflationary impact of a burst property price bubble. Added to this is the problem of budget deficit. Though post-bubble adjustment appeared to have largely run its course, the unemployment rate appeared to be stabilizing. However, the outbreak of SARS has dealt a fresh blow to domestic consumption, investment, and tourism. It is also having significant effects on the business prospects of companies planning to invest in these markets.

Singapore's economy has also not been spared. Although the island-state was applauded for taking stern and proactive measures to curb SARS, the tourism industry which contributes roughly 5% to the GDP, seems to have taken a heavy beating and the weakness looks set to persist. The Singapore International Arts Festival, which usually attracts a lot of tourists, has seen low ticket sales.

The outbreak of SARS has dealt a fresh blow to domestic consumption, investment, tourism and business prospects of companies

The SARS threat has cast a dark shadow on the entire South-East Asian region as a whole. The plans of potential investors and decision makers dwindled since both important nodal points of Singapore and Hong Kong were hit badly by the virus. This has led to postponement of many investment decisions, thereby affecting the economic growth prospects of the region negatively.

Canada too has borne the brunt of the SARS virus. The national government and the Toronto Government reacted angrily to the WHO travel advisory against visiting Toronto. It was subsequently lifted. The Bank of Canada, the country's Central Bank, was in the process of responding to the country's economic strength by raising interest rates.

The addition of Taiwan to the list of SARS infected places could be particularly troublesome for the West since many firms rely on Taiwan as a source of input, particularly on the hardware side—be they motherboards or chips.

From hope to despair

So what does SARS mean to these countries? Has the economic outlook changed for these countries? What is the effect of SARS on the South-East Asian region and what are the global implications? Many agencies have come up with the revision on the growth forecasts for these countries and the region as a whole.

The Asian Development Bank has come out with its scenario for SARS and the impact on growth and GDP in billions of dollars. Its East Asian GDP growth forecast originally pegged at 5.6% is seen at 5.3% if SARS impact is confined to one quarter and at 4.7% if it lasts for two quarters.

According to IMF, China's growth rate is expected to slow by about 0.2% in the event that the epidemic lasts for only a quarter. Yet overall, China accounts for a relatively small share of world trade, making up about 5% of total exports and imports. Such isolation in world trade relative to the US or Euro zone economy is likely to alleviate the impact on the global economy from a prolonged slowdown in the country.

> **"In the currency markets, traders are watching the forward rates on the Hong Kong dollar for markets' expectations of the currency in the future."**
>
> **Ashraf Laidi**
> *Chief Currency Analyst*
> *MG Financial Group*

In Canada, home of the largest Asian community outside Asia, some food and travel related businesses are beginning to feel the impact. Canada's Central Bank said the outbreak had the potential to cut growth this year, but it was too early to say by how much. Yet the bank did cut its 2003 growth forecast last month to 2.5% from about 3% in January.

In Singapore the growth outlook for 2003 has been cut down 0.5% to 2.5%, from an earlier estimate of 2-5%, warning that unemployment could worsen. Forecasts for the entire East Asian region have been slashed by 0.5-1% this year. But it is just as important to heed the resilience of East Asian economies in the aftermath of 9/11 crisis and during the current global economic slowdown. Growth rates in Emerging Asia averaged over 5% in 2001-02, compared to about 1.5% for the advanced economies over the same period. This year, the region is expected to maintain its lead in the world at 6%, compared to 2.2% for the US, 1% for the Euro zone and 0.8% for Japan. Should the SARS epidemic last no more than a quarter, about 0.4% could be shed from the region's growth. All in all, East Asia is equipped with a relatively vital cushion in the event that the crisis takes its toll on the economies in the long-term.

Some of the private institutions are also putting things in

perspective. According to Oliver Stönner-Venkatarama, Member of Emerging Markets Team, Commerzbank at Frankfurt, Germany, "The strongest negative economic impact of the SARS crisis will be felt in China, Hong Kong and Singapore. We reduced our GDP growth forecast for 2003 for China from 7.5 to 7.3%, and we nearly halved the growth outlook for Hong Kong and Singapore to 1.3% and 1.6% respectively. In addition, the spread of the disease and the weakening effect on China's economy dampens economic growth also in the emerging Asian economies such as Taiwan, Malaysia, Philippines and South Korea. On an average, GDP growth in 2003 has been reduced by about 0.2%. For Asia, excluding China and Japan, GDP growth in 2003 is projected to be 4.3% instead of 4.5% because of the SARS effect. Emerging Asia (Hong Kong, Singapore, South Korea and Taiwan) will probably grow 3.8% instead of 4%. In contrast, we revised GDP growth in 2003 for Central and Eastern Europe upwards to 3.8%, after 3.5% in April. Our Latin America growth outlook for 2003 remained nearly unchanged at 1.5%. Therefore, the GDP growth outlook in 2003 for all emerging markets has been lowered by only 0.2% to 4.8%. However, the G7 growth perspective has been revised by 0.2% to 1.8%, but this is mainly because of the impact of the sluggish US growth momentum."

Quantifying economic effect is effectively a shot in the dark. Most estimates are only guesstimates.

Anantha Nageswaran
Regional Head
Investment Consulting
Credit Suisse
Singapore

Economic outlook can also be gauged by observing other indicators like the currency markets. Ashraf Laidi, Chief Currency Analyst at MG Financial Group observes, "In the currency markets, traders are watching the forward rates on the Hong Kong dollar for markets' expectations of the currency in the future. Although the HKD remains pegged to the US dollar at US$ 7.8, the forward rates serve as a proxy for determining the territory's risk premium and hence, the likelihood of an attack on the currency peg to the US dollar. During the Asian currency crisis in 1997-1998, traders largely scrutinized the forward premium for determining probabilities of devaluation. Considering Hong Kong's massive foreign exchange reserves armory, an attack on its currency is far from likely. Yet, the forward rates' effectiveness in gauging the extent of concern is considerable."

But most agree that quantifying the economic effect especially at this point of time before SARS is bought under control is complex. Anantha Nageswaran, Regional Head, Investment Consulting, Credit Suisse based in Singapore agrees. He says, "This exercise is effectively a shot in the dark. Most estimates are only guesstimates. Credit Suisse First Boston has reduced growth forecast by 0.9% for the entire Asia-Pacific ex-Japan. Most research houses have taken down growth forecasts for China for 2003 by more than 1% while the risks for 2004 remain on the downside, though unquantified, as of now."

Well, the impact of SARS on the countries affected severely is being well studied; there is a certain complacency about the adverse impact of SARS on US or other Western powers. SARS would no doubt affect the supply and demand side for some major American corporations. For many companies, Asia has been the only

Fiscal cost of SARS

- Singapore unveiled a US$ 130 mn (S$ 230 mn) emergency package to assist the tourism industry and related sectors. The package consists of a reduction in taxes and dues, and provision of rebates on taxes and fees, bridge loans, and training grants. In support to the health workers, upfront and continuing contributions were made to the Courage Fund, a new fund specifically created for health workers.
- Hong Kong has also announced a package amounting to US$ 1.5 bn (HK$ 11.8 bn), consisting of a reduction or waiver of charges and levies, rent relief, tax rebates, loan guarantees to affected companies, the provision of temporary work and training places, and US$ 128 mn (HK$ 1 bn) to revive the post-SARS economy. Funds were also set aside to further strengthen disease control measures, including a fund for health workers.
- Taipei, China recently approved a US$ 1.4 bn (NT$ 50 bn) fund to be used to defray medical expenses and to support industries hit hard by SARS. This is on top of a US$ 1.7 bn (NT$ 58.4 bn) public works program to mitigate unemployment.
- Among the countries that have been less affected, Thailand has allocated about US$ 468 mn (B20 bn) as an emergency budget. The Republic of Korea, through its Central Bank, earmarked US$ 315 mn (W385 bn) in loans to financial institutions to help support trade financing to cushion the impact of SARS on Korean exporters. On May 2, the Ministry of Finance of Korea announced that it is drawing up a supplemental budget of at least US$ 1.9 bn to reduce the impact of SARS on its exports. Malaysia is expected to announce a US$ 1-2 bn package soon.

Source: Aseansec.org

source of positive demand growth in the last two to three years (e.g., Intel, IBM, CISCO). The degree to which SARS would impact the demand growth is, as yet, unclear but there is little doubt that there would be an impact.

Who are the losers

While SARS has the wider economic implications there are some industries which are particularly hard hit. Tourism and airlines are the worst sufferers. As business travel is reduced and many businessmen cancel their travel, the airlines are affected. Cathay Pacific, the Hong Kong-based carrier has seen its passengers drop sharply forcing it to ground some of the fleet and forcing some of the employees to take unpaid leave. Singapore Airlines has asked all of its 6,600 cabin-crew members to take unpaid leave, and has cut capacity to barely one-third of normal levels.

The lack of travel has undoubtedly affected hotels, taxi tour operators and cruise liners. The fear of SARS discourages people from visiting high concentration areas and this is affecting restaurants, theaters, pubs, concert halls and event managers. The shopping malls are also seeing fewer people leading to depressed sales.

Exports from this region are dipping. April is the boom season for exporters to finalize their orders. If deals are not struck there is loss of opportunity and for sure this will be shown in the export figures for the quarter. The financial markets are also affected as the investors' sentiments are low and public perception and sentiments weigh on the markets.

Surprisingly even the healthcare sector is affected as people are refusing to visit hospitals for fear of coming in contact with SARS patients. In a specific case in Singapore the business and commercial districts close to the hospital where SARS patients were kept, saw a sharp decline in visitors and many employees of the businesses living there staying away.

A number of foreign firms have closed their offices in China or ordered expatriate employees to return home

The supply side or the manufacturing sector so far has not really been affected. Though some of the manufacturing firms saw absenteeism, it was not large enough to stop production. But if the disease persists for long the production might come to a halt and as companies world over are now using Just In Time supply chain management this can have rapid repercussions.

The companies affected hard are the local and regional players. These ripple effects of decreased consumption, postponement of business deals and supply side shocks can also be far-reaching to the headquarters of businesses located away from the Asian continent. Leading airliners in US (American Airlines and United Airlines) and Germany (Lufthansa) have also blamed SARS for falling demand for their routes to Asia, which even lead to discontinuing of several aircrafts.

A number of foreign firms have closed their offices in China or ordered expatriate employees to return home. On May 6, America's Motorola closed its main Beijing office after an employee had become infected with SARS. The world's second-largest mobile-telephone maker told about 1,000 employees to work from home for a week. Philips and Ericsson, two European consumer-electronics companies, have also announced a decline in sales as shoppers avoid crowded malls. Designer brands, cosmetic majors like Bulgari, Bulberry and Estee Lauder have seen sales slip. Even the food retailer McDonald's faced the same problem. Sales have fallen at the hamburger giant's outlets in Asia as customers stay at home. The repercussions of the SARS virus are also being felt in Portland,

Of Wars and Epidemics

Comparisons are being made between the economic impact of wars and epidemics. Wars differ in scope, magnitude and duration. Using the war in Iraq as an illustration, one sees that war's similarity with SARS in curtailing consumer confidence as people stay at home—to watch the war, or avoid masses of people. Another dimension to the economic impact is that wars generally place a larger burden on government expenditures and the budget, than an epidemic such as SARS. Both the repercussions of wars and SARS can reverberate throughout the traditional economic channels of demand, production, employment and government expenditure. But the impact from SARS on these economic channels is much more abrupt and sudden than in the case of wars as closings of factories, restaurants and other establishments can take place in without prior warning or indication. In other words, a company can plan ahead and start gradually holding back from spending ahead of an incipient war or during the course of a war. With SARS, business shutdowns are subject to the mercy of new cases, whose predictability factor is much more significant. In the case of epidemic, neither the beginning nor ending of SARS cases can be predicted, which hinders markets' ability to 'price in' the impact of the epidemic.

The result of a war is also quite clear, there is a winner and a loser. Regarding SARS there are only winners or losers. Despite all differences the countries have to stand together to fight the virus, otherwise everyone will lose. However, everyone agrees that compared with other catastrophes, such as war, the economics of disease outbreaks is remarkably under-researched.

Oregon, headquarters of Nike, the world's largest sports goods maker. Nike has its operations in China, Indonesia, Thailand and Vietnam employing more than 3,00,000 people. The number of business trips have been cut by half. E-mail, telephone, videoconferencing are the only means to keep in touch. If the disease is not bought under control in six to 12 months, then contingency plans are made to shift production out of Asia to most probably Latin America. David Wyss, Chief Economist at Standard & Poor's, in New York also echoes similar views. He says, "Supply disruptions could shift some production from China and South-East Asia to areas unaffected, such as Latin America, India and Pakistan. This is easiest for toys and clothing—more difficult for high-tech. Companies are hedging the risk by diversifying their sourcing. Companies are actively talking to producers outside China, particularly for toys, apparels, and footwear."

Business continuity

Can the companies hedge their risk? Is there a way to reduce the risk? There is obviously no specific way to hedge against SARS but simple diversification strategies like diversifying, sourcing geographically can help. Even on the sales side companies can have clients and consumers in different regions rather than focusing on one geographical location.

> **The epidemic has also brought forth the importance of being able to distribute relevant information quickly across geographies. Technologies that allow this will see good demand.**
>
> **Ravindra S Datar**
> *Principal Analyst*
> *Gartner India Research & Advisory Services*

Laidi prescribes, "Equity portfolio managers can reduce their allocation to sectors in most likely to be impacted or already exposed to SARS. Airline stocks, hotel chains and food establishments are potential negatives. Electronics and communication companies as well as multinationals with significant plants in the region are also exposed to the risks of disruptive operations, shutdowns and falling demand. Firms specializing in remote telecom services and drug stocks could be a boon. Portfolio managers should heed these factors when making their allocation (holdings compared to the benchmarks) and selection (stock picking) decisions. While it also makes sense to hedge against the decline of currencies in the region, it remains to be seen to what extent will these currencies post any overall decline. The Singapore dollar, for instance, rallied to two-month high in early to mid-May. And while the Chinese yuan remains fixed, the Hong Kong dollar is pegged against its US counterpart, sustained by a massive currency reserves armory of nearly $113 bn, the fifth largest reserve in the world. Taiwan, the other country affected by SARS, has $167 bn in reserves, the third highest, after Japan and Mainland China."

Ravindra S Datar, Principal Analyst, Gartner India Research & Advisory Services sees the importance of Business Continuity Planning and Disaster Recovery strategies. He says, "DR/BCP planners worldwide would start considering pandemics in their DR/BCP plans. Usually, disruptors like storms, floods, earthquakes, fire and war are taken into consideration, but the recent SARS pandemic has brought forth the importance of considering other

> **Medical industries are expected to benefit from an increased demand in general healthcare. Whoever discovers the cure to SARS can expect a windfall.**
>
> **Glen Burns**
> *Editor,* INS News

reasons too where the facility may not be physically damaged but for some reason, people may not be able to go to the facility to do their work. Imagine what would happen if none of the offshore call center employees in say Mumbai or Bangalore or Delhi, are able to go to work for many days due to reasons like these. The epidemic has also brought forth the importance of being able to distribute relevant information quickly across geographies. Technologies that allow this will see good demand. All the same, though the technology may be able to do so, it is important to put policies in place ('Action Stations Routines') for the technologies to be used effectively. This is necessary to ensure transparency of information and the related decision-making and also to avoid panic moves leading to chaotic situations."

Stönner feels that the real way to hedge the risk is by making the governments accountable. He says, "There is no way to hedge against SARS risks, if you want to be present in the fastest growing region of the world economy. However, international companies are in a strong position to demand improvements in health and hygiene situation. In this case, the emerging economies will pay more attention to enhance the public

infrastructure to attract more direct investments."

A few winners

Among the mess created by SARS there are a few winners. According to Glen Burns, Editor, *INS News*, "Medical industries are expected to benefit from an increased demand in general healthcare. Whoever discovers the cure to SARS can expect a windfall." Though the public institutions do most of the work there would be a positive impact on the medical research industry.

Other gainers include the makers of remote access telecommunication facilities such as videoconferencing, and makers of traditional herbs and western drugs, both of which are increasingly combined as preventive measures to fortify immune systems. Companies specializing in textiles clothing can also branch out into the making of masks. DVDs and VCR rentals, and sales of 'instant recipe' culinary businesses also benefit, as people tend to stay at home. Travel to regions that are secluded from the crisis such as the Americas, Southern Europe and Africa is also expected to replace the decline in travel to East Asia. This is also a good time for the insurance companies selling health insurance and other forms of business risk insurance. They have reported an intense level of interests since the SARS outbreak. Traditionally these types of insurance have been difficult to sell in Asia.

If problem prolongs .....

Though the effect of SARS is limited, it could make a lot of difference if it persists for a long time. A prolonged SARS crisis, say into the middle of summer, could have serious ripple effects that go beyond travel and tourism. Increased factory closings due to some infected employees will not only retard industrial activity, but also impact the overall production process, which in turn spills over to curbing orders and deliveries by suppliers and retailers. That in turn will weigh on corporate performance, obliging companies to freeze hiring as well as layoff workers. Consequently, this would dampen consumer confidence, hinder capital formation and liquidity, and trigger market sell-offs. And since the Asian economies are increasingly tied with China through trade, the China 'phenomenon' could easily reverberate through trade channels. Only in a situation where the 'long-term' exceeds six to eight months, will East Asia-bound foreign direct investments drop, and vital foreign exchange flows recede.

According to Laidi, "An especially ominous occurrence of a long-term SARS crisis is the impact on global demand by Emerging Asia and the ensuing result on global prices. Part of the reason that oil prices plummeted below $10 in autumn 1998 was the fall in Asian demand resulting from the currency crisis in that region. With inflation already tepid in the industrialized world, falling demand and strong currencies in East Asia could eventually start importing disinflation tendencies, which in turn will exacerbate the global price picture and raise the risk of global deflation. Yet if the disease is contained soon, the macroeconomic impact in Asia should be manageable given the robustness of the economies in the region, and the impact on the global economy should be limited."

Stönner speaking on the long-term challenges says, "The long-term challenge particularly for the Asian countries is to find ways to accelerate the flow of information and to improve the cooperation within the region to prevent diseases like SARS from spreading in the very densely populated Asian countries like China and India. Especially, China's administration should have understood the message that a free flow of information is absolutely necessary for a stable economic development."

> **"The emerging economies will pay more attention to enhance the public infrastructure to attract more direct investments."**
>
> **Oliver Stönner-Venkatarama**
> *Member of Emerging Markets Team*
> *Commerzbank, Frankfurt*
> *Germany*

Governance and macroeconomics

The role of the government in controlling such outbreaks has increasingly come into focus. China has been criticized for mishandling the SARS epidemic. The Chinese Government has been very secretive about the information on SARS and even refused to initially let in WHO experts to enter the country. Tiffs between China and WHO is nothing new. WHO has already accused China of not being open on the HIV/AIDS epidemic? It is predicted that China would have 10 to 12 million HIV cases in the next five years.

While the Chinese Government can be secretive about the spread of SARS it would not go well with the potential investors. There are also skeptics who doubt the economic figures published by the Chinese government. The governments play a very important role in not only controlling the spread of the disease but also in boosting the investors' confidence. The loss of confidence was due to suppression of information and conflicting reports leading to a situation where the credibility of the information being released officially was being suspected. It is important for the governments to

demonstrate their willingness and take concrete steps towards bringing transparency in the flow of information. The governments also need to set up credible systems in place to tackle such emergencies in places where authentic information is easily available without selective suppression and the right decisions can be taken speedily.

A fundamental duty of any government in controlling the spread of SARS is to properly insulate healthcare workers treating patients, as they are most susceptible to catching and transmitting the disease. Establishing a credible framework for improving transparency and accountability amid government and health officials will help alleviate the risk of eroding confidence by both portfolio and direct investors. Coordinating care, controls, and progress monitoring between local authorities and global bodies such as the WHO will also help secure a vital stamp of approval.

The role played by WHO is also commendable. Anantha Nageswaran, applauding the work of WHO says, "The WHO has clearly demonstrated its usefulness with an effective orchestration of the response to the crisis globally. It was right to raise the alarm early and loudly and kept the public well informed through its rigorously objective press releases almost daily. It also marshaled global clinical and biological resources to diagnose and to develop a cure for the disease caused by the virus."

Early access to WHO experts would not only help in early diagnosis but also prevent the spread of the disease

He further adds, "It is hard to visualize a single nation achieving this rare feat of persuading usually reclusive research laboratories to collaborate and share information. It was possible because of the non-partisan and 'elder brother' approach of the WHO. There could not have been a better demonstration of the usefulness of multilateral institution."

There is also an important issue to be addressed by the multinational institutions. While the nuclear and chemical weapons can be checked by experts unconditionally there is no such provision for WHO to enter countries where the outbreak has taken place and have an unconditional access to patients and the hospitals. This would not repeat what has happened in the SARS case. Early access would not only help in early diagnosis but also prevent the spread of the disease. Think about the risk, if the virus hits Africa. The virus would spread like AIDS, hindering the economic development process to gather some momentum. Therefore, the governments have to make a huge effort to prevent the virus from spreading.

The big question

The big question in everybody's mind is when would the economy come out of the clutches of SARS? This depends on the time taken to bring the epidemic under control and then eradicate it conclusively and also the geographical scope of spread of the epidemic before it is capped. This will also depend on time taken to re-build investor confidence and also to normalize the travel infrastructure and schedules. Singapore and Hong Kong are major nodal points for travelers from West to East and vice versa. The sooner these get purged of the SARS epidemic, the better it will be for the region.

The time taken to bounce back would depend on how long it takes for the number of cases to come to a complete stop. These cases include suspected infections, actual infections as well as deaths. Without this, businesses, investors and even consumers shall find it hard to bring back the level of confidence prevailing prior to the breakout. Consequently, travel advisories will have to be lifted, and public activities such as eating out, shopping, conferencing and other mass gatherings will help in shoring up optimism. One must be careful in assessing the causal relationship involving the global slowdown prevailing prior to SARS, and the economic effects arising from the pandemic.

> **"The manufacturing and other domestic sectors will come out quickly, but it could be a year before the negative impact on tourism is over."**
>
> **David Wyss**
> *Chief Economist*
> *Standard & Poor's*
> *New York*

Wyss, while looking into the future says, "The manufacturing and other domestic sectors will come out quickly, but it could be a year before the negative impact on tourism is over. Tourists have other places to go, and even small fears will redirect travel. If the disease spreads, industries like toys, apparels, and perhaps most importantly, computers will be affected because lack of business travel will discourage new contracts and deliveries could be problematic."

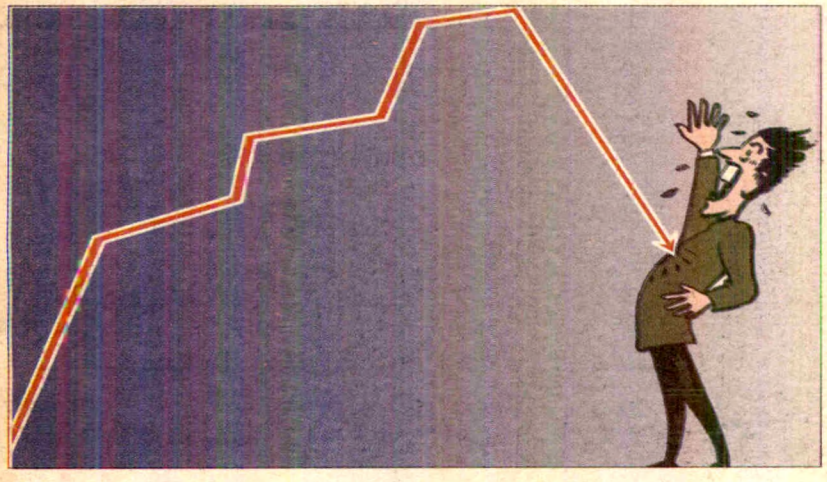
D Satish and N Janardhan Rao

Reference # 1-2003-06-02

NASDAQ'S WOES

Life beyond 'tech'

The premier stock market for outstanding technology companies is shrinking. Are the problems endemic to Nasdaq or is the condition of the economy to be blamed?



Nasdaq, the world's largest electronic stock market, home to more than 3,700 companies including some big names in technology and media has been losing value for some time now. The bursting of technology stock bubble, dearth of IPOs, low corporate earnings, accounting irregularities, job losses and the economic downturn, have contributed to its current woes. The Securities and Exchange Commission's (SEC) insistence that US listing go hand in hand with US GAAP accounting standards has also resulted in delisting of over 2,600 companies since 1999. While all these are external contributors to the Nasdaq woes one cannot overlook the problems of its own making. Nasdaq's decision to expand its reach to worldwide markets has been an expensive, path-breaking process and the gains perhaps have not yet been reaped.

Problem of penny shares

During the boom, investors opened the doors and created companies that qualified for Nasdaq listing, that now in retrospect should not have been Nasdaq listed or even public companies. To stay on Nasdaq top-tier trading venue, the Nasdaq national market, a company generally has to have a stock price of at least $1, public stock valued at a minimum of $5 mn, and at least 750,000 shareholders among other criteria. The national market is a home for Nasdaq prize listed companies, such as Oracle, Intel, Microsoft and Cisco Systems. Many small companies trade on the lower-tier Nasdaq small cap market, where companies must also trade for $1, but shareholder and public-stock value requirements are lower. Since September 11, 2001 an estimated 11% of the companies on Nasdaq have been trading on the delisting danger zone of below $1 a share. These penny stock companies have been given a period of 360 days to improve their stock prices provided they have a viable turnaround plan, failing which they would be traded on the OTC bulletin board which is loosely regulated by Nasdaq or the pink sheets which is a barely regulated private quotation service where these companies are not required to file regular financial reports.

Ted Azarmi, Faculty, California State University, US, and Christine Haecker, Research Fellow, Universitaet Tuebingen Germany, say "There is no theoretical basis for stockholders, listed companies, or the Nasdaq market to have a preference for stock prices to be traded above $1 or in a range of $1 to $100 (for example). That is, the valuation should be the same, if a company has 100,000,000 shares worth $1 each or 1,000,000 shares valued at $100 each. All that matters is the net present value of the future cash flows that are derived from the growth opportunities that a firm offers and hence there should not be an impact if the rule that listed companies must trade above $1 on the shareholders, companies and Nasdaq itself." However there are both psychological and practical reasons to stay away from trading and investing in stocks that are under a dollar or penny stocks in general. The psychological reason is that these stocks have a stink of death about them. Investors feel that penny stocks are issued by firms that cannot keep their valuation at a reasonable per share price of above $1. If a firm's share price falls under a $1, one can infer that the firm has failed and does not have future opportunities for growth. The practical aspect of penny stocks is that they are obscure and known through a listing called the pink sheet. Fewer people obtain stock information and follow share price developments. Hence these stocks are more volatile, less liquid, and therefore risky. If Nasdaq gets a reputation for being a market that trades a lot

Another bright performance
Shining with success

Union Bank of India's Performance (2002-03)

Net Profit increased from : Rs. 314 to 553 Crs.
Capital Adequacy Ratio increased from : 11.07% to 12.41%
Net Worth increased from : Rs. 2,107 to 2,567 Crs.
Net NPA decreased from : 6.26% to 4.91%

Rs. in crores

	As at 31.03.2003	As at 31.03.2002
CAPITAL AND LIABILITIES		
Capital	460	338
Reserves and Surplus	2,106	1,769
Deposits	44,749	39,794
Borrowings & other Liabilities	3,745	2,457
Total	**51,060**	**44,358**

Rs. in crores

	As at 31.03.2003	As at 31.03.2002
ASSETS		
Cash and Bank Balances	3,899	4,906
Investments	19,371	15,410
Advances	25,515	21,383
Fixed Assets	733	738
Other Assets	1,542	1,921
Total	**51,060**	**44,358**

Achievements of 2002-03

- 20 branches networked under Core Banking
- 102 ATMs installed
- Corporate agency for Life Insurance with HDFC Standard Life and Non Life Insurance with New India Assurance
- Sale of Gold
- Tele-banking at all CBS branches
- 64 branches & 3 extension counters recommended for certification (conforming to ISO 9001-2000 Standards) by M/s. BSI India Pvt. Ltd.
- Distribution of Mutual Fund products
- Cash Management Services offered
- 11 Retail Products

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in penny stocks, mainstream investors and perhaps those who are obligated by fiduciary duties to make prudent investment decisions may stay away from the markets. Jeff Harris of Alfred Lerner College and a visiting academic fellow at Nasdaq says, "For investors the dropping of the rule would make sense as millions of shares are traded everyday. Without minimum listing prices, these shares could be executed on the existing Nasdaq systems. The tape revenue (money earned by exchange based on the trades executed there) would increase for Nasdaq for sure. The process of kicking firms off for minimum price violations imposes legal costs on the companies and their shareholders and labor-intensive hearings on the part of Nasdaq as well. The price restrictions also encourage reverse stock splits simply for the purposes of avoiding the delisting. These financial shenanigans serve little economic purpose for the company by distracting management from operating activities. Investors have historically looked poorly on such moves, figuring they are a last-ditch gimmick to get the price over $1 and stay listed but do nothing to improve a company's prospects. But some investors say reverse splits may be getting a new respectability after large companies like palm, AT&T and Lucent have taken them. A reverse split does not actually really serve the Nasdaq market's need since it reduces the number of outstanding shares and the listing fees are based on the number of shares."

Competitive trading platforms

On October 14, 2002 Nasdaq launched supermontage, its next generation transaction system. Supermontage was implemented in nine phases and traded all Nasdaq stocks by December 2002. Supermontage was designed to centralize liquidity in Nasdaq listings and to provide market makers with a platform that offers order protection and superior executions to investors. However, Nasdaq Supermontage proposal took nearly three years to gain approval from the SEC which allowed Nasdaq competitors to add computer-based enhancements to their services with minimal regulatory delay, as a result it was unable to capture the market share as anticipated. Besides diverting trades from Supermontage, both Archipelago and the Instinet-Island combination plan to squeeze Nasdaq by reporting their trades on other exchanges, thus claiming the revenues that Nasdaq otherwise would receive from reselling quote and trade data to brokers and investors. Nasdaq will have to develop a plan of action to win back market share and one way of doing that might be the acquisition of Archipelago, a move that Nasdaq seems to be considering at the moment. Thus as liquidity is the stock market's life blood, it is essential that Supermontage gains and holds a large share of trades if not the consequences would be serious.

Nasdaq's IPO plans

Nasdaq's IPO plans have been long in the making. New listings on Nasdaq provide a major source of revenue in the form of listing fees and Nasdaq performance disproportionately depends on the IPO market. However, the outlook for IPOs is not very encouraging as it was in the previous years. This year the IPOs' market is very weak and very few IPOs have been made as compared to that of last year. There have been three major IPOs this year raising about $500 mn. There were 16 IPOs on Nasdaq during the fourth quarter of 2002 compared to 24 IPOs in the fourth quarter of 2001. Negative IPO market conditions, poor investor sentiment and falling markets make Nasdaq plans for IPO vulnerable.

The Japan venture

Nasdaq is one of the few exchanges, which aims to be a truly global exchange. The Nasdaq strategy to share its listings with other global markets was aimed to provide greater access to capital for companies, more liquidity and a broader investor opportunity. Nasdaq Japan was launched on June 19, 2000 within the Osaka exchange for Japanese venture businesses and was to be a globally credible exchange where Japan's ambitious start-ups could list. Nasdaq and Japanese investor Softbank Corp. were the two biggest shareholders in Nasdaq Japan, each owning a 43% stake in the joint venture. It provided an opportunity to local investors to buy Nasdaq stocks, as well as an index that tracks the US Nasdaq's top 100. However, the Japanese venture failed and was eventually closed in August 2002 and $15.2 mn was written off. The exchange was launched in a booming economy and during a period of wild growth for the Nasdaq. However, later the market declined, and dotcoms had fallen on hard times. Tech stocks in particular took a beating. Only 98 companies had listed on the Japanese exchange by the end of its first year of operation. In contrast, the rival Jasdaq market, which is run by the Japan Securities Dealers Association, boasts more than 900 listings. Nasdaq Japan, the TSE mother market and Jasdaq are the three emerging company exchanges in Japan, with Jasdaq being the largest of all.

Azarmi and Haecker say, "Closing down of Nasdaq Japan was the right move and Nasdaq had to cut its losses and get out of the venture. Japan has fundamental inefficiencies in its labor and capital markets, banking problems, and a lack of solid corporate and governmental leadership, thereby making the Japanese stock market unattractive for the foreseeable future. A weak economy and shrinking number of listings have put a good deal of pressure on Nasdaq Japan's bottom line.

Nasdaq's plans to develop a global brand and presence of the startling success and rapid growth

it experienced during the 1990s boom in the US has led to unimpressive results related to forays into Europe and Japan."

Challenges ahead

Rise in oil prices and the Iraq war crises have led to the fall of stock markets globally and Nasdaq is no exception. The recent accounting frauds and repeated profit warnings quarter after quarter by big time players in the US markets has led to the stocks taking a beating on the exchange and would definitely take a long time to heal. The consumer as well as the corporate spending is not much impressive to boost corporate growth in spite of several cuts in interest rates by the Federal Reserve.

Nasdaq has taken up the challenge and has been taking several initiatives for its revival and to emerge again as the world's largest and most successful stock market. Among its recent initiatives Nasdaq has proposed a measure on January 29, 2003, which provides an option to listed firms that meet higher financial requirements to take an extended compliance period to satisfy minimum bid price requirements. The details of the proposal are as follows:

- Extending the bid price grace period for all national market issuers from 90 calendar days to 180 calendar days, and providing an additional 180 calendar days grace period for those national market issuers able to demonstrate compliance with the core national market initial listing criteria.
- Maintaining the initial 180 calendar days bid price grace period for all small cap issuers, but extending the bid price grace period for small cap issuers demonstrating compliance with the core small cap initial listing criteria from 180 days up to 540 days (approximately 18 months), compliance with this standard would be verified every 180 days.
- Extending the pilot program expiration from December 31, 2003 to December 31, 2004.

There is also the primex proposal that seeks to bring some aspects of auction market mechanism to Nasdaq dealer-focused trading platform. This would provide investors with an opportunity to receive prices that may improve over the bid and offers displayed by the dealers. However, Nasdaq has to walk a fine line between dealers' interest and those of the investors, to ensure that the primex system succeeds. Nasdaq lists and trades more shares per day than any other US market and hence it is important that Nasdaq prioritizes its service and keeps its large number of dealers satisfied. Nasdaq's success in the past has been its ability to attract leaders in certain high growth industries such as technology and communications. The real challenge would be to identify other sectors that have a potential to grow in the next decade the way technology and telecommunication firms have grown in the 1990s. Nasdaq also has a new trading platform the supermontage, which it plans to roll out globally into various markets such as Europe and Asia.

Nasdaq has proven to be a formidable trading venue as compared to the American stock exchange and other regional US stock exchanges

Harris says, "Nasdaq itself has tremendous brand recognition and provides an extremely trading venue for a wide variety of companies. The NYSE (New York Stock Exchange), for instance, simply refuses to list smaller companies. Nasdaq has proven to be a formidable trading venue as compared to the American stock exchange and other regional US stock exchanges. Companies gain great liquidity and analyst coverage from Nasdaq listing. Access to the capital markets has been one of the key drivers in the success of Microsoft and other less visible, but highly successful firms. Nasdaq market makers provide a valuable service in producing and disseminating company-specific information, which is not integrated into the trading systems of many competitors. Nasdaq should be able to leverage their status as the central listing venue for smaller stocks and IPOs. Nasdaq has a very bright future as it serves not only the small and mid-cap markets but recent evidence suggest that Nasdaq compares well (based on bid-ask spreads and speed) to the NYSE for trading in the largest stocks as well. When the markets turnaround and as investors come back, Nasdaq should be poised to capitalize."

The Nasdaq market is currently one of the worst bear markets in history and the technical damage would not get repaired overnight. The overhang from the 1990s bubble could last for years. Most of the market participants are holding on to stocks in hope that history would repeat itself and once the economic and overseas problems are overcome, the markets would again reach their peak as it had done during 1991. However, the overall global economic scenario is bleak and the markets worldwide have taken a severe beating. This downtrend is a temporary phenomenon and the markets would recover once the overall economic scenario improves. Thus, Nasdaq through effective leadership, has to initiate various measures and needs to capitalize on the quality of its market and supermontage technology to be still known as the world's largest and successful market benefitting the investors as well as fueling the economy.

Sanket D Padhye

Reference # 1-2003-06-03

STOCK OPTIONS

Repricing trade-offs

Despite pressures from regulators and shareholders, firms are persistent about repricing the underwater stock options. But, contrary to the general view that repricing harms the interests of the shareholders, it might actually enhance their returns.

While the instability of stock markets during the late 1990s saw fortunes of many public investors dwindling, one set of stakeholders (i.e., employees) were protected from this loss thanks to the 'repricing' of the underwater stock options. Stock option repricing is nothing but issuing of new stock options at the existing market price, in place of the stock options whose strike (exercise) price had fallen below the market price. By doing so, companies effectively restore the value of issued stock options which have gone underwater. This also helps them to retain their talented employees during tough times, who otherwise might leave the company for better prospects.

The above argument was, in fact, verified by two professors, Luann Lynch of Darden University and Mary Carter of Wharton in their research paper titled 'The effect of stock option repricing on employee turnover'. "While we are unable to document any decrease in executive turnover associated with repricing, our results suggest that repricing stock options held by non-executive employees may help to retain those employees. There is some evidence that repricing does help curb employee turnover," says Lynch.

Stock options are primarily a commitment made by a company to its employees for offering a limited number of company's shares to employees at a set price, for a set period of time. If the stock price rises above what was offered by the options (i.e., the strike price), then the employees who own the stock make good fortune. Instead, if the market price falls below the stock price, the option is said to be 'underwater' or useless.

Since the last few years, companies have made employee stock options a key element of compensation package. However, the effectiveness of these stock options as a means to retain the employees decreases if they go underwater. It is here that 'repricing' plays an important role in making the stock options instrumental in employee retention. Repricing is generally done through one of the two approaches; by means of canceling an existing option, which is followed by issuing a 'regrant' at a lower exercise price or by amending an outstanding underwater option to reduce its existing price.

The strategy of repricing underwater stock options has caused a lot of controversy for many reasons. The major argument being that the financial performance of any company is the result of working of the employees, and the employees need not be protected from poor financial outcomes.

Observers consider repricing underwater stock options as counterproductive to the intended purpose of equity compensation (i.e., using the option grants for tying employees interests to corporate performances). But, companies regard stock options repricing as an investment to retain their talented employees. Dr. V V L N Sastry, Country Head, First Call Equity India, agrees to this argument. He is of the view that, "Repricing is a natural phenomenon in the services industry, where the talent pool creates value and maximizes the shareholders' value." He further adds: "To retain the talent of employees, repricing is a must option and shareholders need not contest this, as the very shareholder value is going to get enhanced with the services rendered by employees. Hence it is a win-win situation for both the employees, employers and the shareholders to reprice the underwater stock options and create value with the enhanced contribution of employees. After all, the service-oriented organizations have to run on the talent of the employees."

Lynch argues that, "If companies reprice, it may be that they feel the benefit of repricing outweigh the negative publicity."

Repricing also enables firms to drastically bring down the employee turnover costs. This sentiment is vindicated by many surveys, which have established the fact that frequent employee turnovers are very expensive to companies. These surveys estimated that the cost of turnover for a high technology company varies from 50% to 200% of the annual salary of an employee. Thus, in spite of the controversies, repricing of the underwater stock options actually result in the conservation of funds for a company by giving employees a stake in the company.

Repricing: The problems

While the desire of companies to retain their able employees by repricing their underwater stock options is appreciable, the fact that it is being done at the expense of the public investors is undesirable. The management normally initiates options repricing without the approval of their shareholders. In most of the cases it was observed

that the shareholders are not inclined to such practices. The general belief is that the shareholders are not favorable to repricing, as they do not have the opportunity to reset their options. The shareholders' discontent is mainly because of their belief that, as a result of repricing they are compelled to take the brunt of the falling stock price, while a class of option holders are relatively undisturbed by a sliding stock price. They also feel that there would be a lot of dilution in Earnings Per Share (EPS), while in actual terms it might not be so. "In the event of repriced stock options, there will not be any impact on the revenue account of the company, but there will be increased shareholding, which will partially bring down the EPS value, however with the value drivers of services offered by these companies, the decrease in EPS can well be compensated, as the P/E multiple is market driven. Hence, it is a better option to reprice," argues Dr. Sastry.

Companies that go for repricing the underwater stock options in a hurry without considering the various legal and accounting aspects might actually end up in a mess. The point which makes the whole practice of 'repricing' a complex phenomenon is that the companies which offer repricing, should adopt 'variable plan accounting' procedures, where the difference between the strike price of new options and the fair 'market' value should be charged against each quarter's earnings. While the regulatory bodies were not so particular about such 'non-cash' charges earlier (until three years back), now these are being observed carefully.

The firms, which opt for repricing underwater stock options, should try to regain shareholder confidence by taking appropriate measures while repricing stock options

Regulatory obligations

By repricing the underwater stock options, the companies are removing the risk of the devaluating stock from the employees' shoulders and placing this risk directly on the shareholders. Clearly, this is not in line with the interests of the majority of public shareholders, as the process would dilute their earnings. To stop companies from aggressively pursuing the practice of repricing underwater stock options and to address to the concerns of the shareholders, the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) proposed some measures, which the employers should consider before repricing the stock options. Prominent among them are the 'variable accounting', proposed by the FASB, which "requires a company to take a compensatory charge every quarter to the difference between the exercise price of the option, as repriced, and the fair market value of the stock at the end of the quarter." The danger with this compensation charge is that large decrease in earnings can happen if the stock option bounces back after repricing. Also, calculation of the charge becomes very hard until it is actually fixed. This rule is likely to reduce the volume of stock options issued, as the employers have to show the charges on their P&L accounts.

Another important measure that is going to be made mandatory by the New York Stock Exchange (NYSE) is that "shareholders should be allowed to vote on all equity-compensation plans, except only under certain situations like mergers and acquisitions. That is to say that all plans relating to repricing of options would generally need a shareholder vote. Even Nasdaq is contemplating to introduce this rule. If these rules are adopted, then the companies might have to give more explanation to their shareholders on the issue of repricing of the underwater stock options.

"The non-employee shareholders need to take a lenient view that it is the employees in the new economy who create value for the company and they need to be compensated accordingly to keep the shareholders value and to further add to the value in the long run.

Dr. V V L N Sastry
Country Head
First Call India Equity Pvt. Ltd.
Mumbai

Alternatives to repricing

There has been a lot of work going on for better alternatives to replace repricing practice, for the obvious reason of tax advantages, to get away with the effects of variable accounting and also to establish a trade-off between shareholders and the employees' interests. The '6+1 option exchange' is one such alternative that has gained prominence in the recent past and in fact it was already implemented successfully by a company called Brocade Communications Systems, based in California, while repricing its underwater stock options.

Under normal circumstances, firms that reprice options or cancel and regrant new options within six months may have to take a charge to earnings. In the '6+1 option exchange', companies, which intend to reprice their employees' underwater stock options, cancel the currently held options and issue new options after six months and one day. In this new form the firms

"Repricing may particularly be necessary in times of prolonged market downturn as the sagging stock price is not a reflection of the incompetence of employees or management but a result of lackluster general market conditions."

Dr. Y Subba Reddy, Senior Lecturer, Finance, School of Business, Curtin University of Technology, Malaysia.

O Despite many regulatory pressures and wrath from shareholders, why are many companies still preferring to reprice underwater stock options?

Repricing underwater stock options appears to be a necessary evil. Very often it could be the only rational choice available to shareholders who like employees' wish to see that the price of their stock goes up. Repricing may improve the 'handcuff' benefit that invested stock options may afford a company as employees' hopes are still kept alive. Repricing may particularly be necessary in times of prolonged market downturn as the sagging stock price is not a reflection of the incompetence of employees or management but a result of lackluster general market conditions. Of course, repricing could be a double-edged sword. If employees expect repricing whenever stock price is bound southwards, their incentives may not be best aligned with that of shareholders. Repricing in this context incentivizes employees to take actions that may lead to heightened earnings volatility and consummate in another form of expropriation of shareholders by employees. In this instance, employee stock options instead of aligning employee interests with that of shareholders, may actually engender a greater degree of conflict of interest.

O Does the 'Repricing' exercise really benefit employees? What are the problems faced by employees during the repricing exercise in terms of their finance, tax and career?

Repricing should be an exception rather than a rule. Underwater stock options at times may create disincentives for employees even when they expect the stock price fall to be a transient phenomenon. This may be

dictated by an employee's particular situation where he may have liquidity requirements or he may be on the verge of retirement. Under such conditions, repricing may be imperative. However, such repricing path need to be tread cautiously by companies. During the repricing exercise employees may be exposed to the market vagaries as if the price fluctuates upwards, during this period the repricing is set at a higher price than the earlier price. Similarly, the repricing exercise may also have tax implications for employees as this resets the capital gains tolling period. Similarly in the time that lapses during repricing, an employee may leave or may be laid off constraining him to reap the value left in the underwater stock options. Repricing may not thus

need not require a charge to earnings, because they wait for six months and one day to reprice or issue regrants to the underwater stock options. Lynch is of the view that since the FASB's definition of stock option repricing included both changing the exercise price of existing options and canceling and reissuing option within a six-month period, companies have begun canceling and committing to reissuing options more than six months later and thus avoid the expenses associated with traditional repricing

Dr. Sastry says, "One of the first and more popular planning devices for avoiding the effects of variable accounting takes place when a firm cancels underwater stock options and six months and one day later grants new options equal to the value of the previously canceled options. While the issuer of the stock options may commit upfront to the issuance of new options, the price of the options may not be committed until at least six months and one day after the exchange offer and must be the fair market value of the securities on the date that the new options are issued."

In addition to this, a few other alternatives have been proposed like cash compensation and others. But these alternatives have their own negative aspects. Like in the case of cash compensations, says Dr. Sastry, "companies tend to incur lot of revenue costs, which they may not be in a position to afford, which also reduces the profitability of the companies drastically thus affecting the per share earnings and the value of shareholders." He further adds, "through repriced stock options and by increasing their holding, companies will not be the direct losers as their exit from the stocks is market dependent, if they are listed companies and the market determines the prices and pay, upon exits."

Regaining shareholders' trust

The awareness among shareholders and vigilance by regulatory authorities has increased in the last two years because of various corporate scandals that have taken place like Enron and others. The controversy over repricing of underwater stock options can thus be linked to these debacles,

be a preferred choice for employees, but should the circumstances dictate chronic underwater stock options, it may be their only savior.

O Are there any other alternatives other than repricing for addressing the problem of underwater stock options?

One alternative that could alleviate the problem of underwater options is grant of stock options on a periodic basis at regular intervals rather than offering them at one go. Such option grant should take into consideration over and under market valuations. By granting more employee stock options when the stock prices are low and granting few when the stock prices are high employees may be allowed to build a price diversified stock options portfolio. This scheme of variable pay may lead to a better compensation structure rather than offering employee stock options that may all go underwater.

O What is the impact that repricing of stock options is going to have on shareholders' revenues and on the accounting books of the issuing companies?

Increasingly everyone is coming around to agree with the views of the world's best-known legendry investor Warren Buffett, who once asked, "If stock options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world do they go?" The case would not be very different in case of repriced stock options. Repricing is certainly going to improve the value of stock options to employees and the same should be reflected in the books of companies. Repricing is all the more a reason why employee stock options need to be expensed. Of course the issue of when to make a charge appears to stay unsettled for a while to come. The principle of conservatism dictates that vesting-date method may ultimately prevail over the grant date or the exercise date.

O What should be the position of stockholders regarding the stock options repricing? Is repricing stock options a right strategy in the interests of shareholders?

Repricing may be a bitter pill that stockholders should be prepared to swallow. It may be the only strategy available to them when they expect their ship to sink when employees leave in search of fresh meadows. Of course, the necessity of shareholder approval for repricing is still a contentious issue. In cases where repricing is only granted to employees and not to top management, not requiring shareholder approval may not be very controversial. Placing in a few safeguards such as restart vesting and a block-out period and barring top echelons of management may prove to be a remedial strategy in the pursuit of best interests of stockholders.

Repricing is a challenging issue involving stockholders, employees and top management. It has to been seen fair by everyone concerned including other stakeholders. Caution is advised particularly as it shouldn't be shown to tilt the weights in favor of employees.

especially at a time when the stock markets across the world are held up in a slow-performance phase.

Thus, repricing of the underwater stock options is expected to be carried out in a decent and transparent manner by the shareholders, the regulators and the general public.

The firms, which opt for repricing underwater stock options, should therefore try to regain shareholder confidence by taking appropriate measures while repricing stock options. The firms should keep in mind that repricing is a one-time settlement process which cannot be done too frequently. Also, repricing should be viewed as an alteration to a problem, like correcting a poorly determined original exercise price that was set when the stock was at its unusual inflated rates. If possible, companies should try to avoid repricing options of those employees who have a major say over the financial performance of the company. If not, there is a danger that shareholders might regard these employees as those who are trying to avoid responsibility for falling stock prices. After all, top managers and executives are responsible for major fluctuations in a company's stock.

Another cautious approach is to reprice the options of only those who do not have any influence over the falling stock price of the company or those irreplaceable employees who are expected to leave and work for a competitor.

All said about safeguarding shareholders' interests, it is for the companies to decide whether repricing is the right strategy for retaining employees. If a company feels that keeping these employees would benefit the interests of the shareholders in the long-term, then, of course repricing can be done. At the end of the day it is the firm which is affected and the failure to do so may cost the company to lose able and talented employees in the present day competitive environment, which is fast becoming a dynamic competitive market.

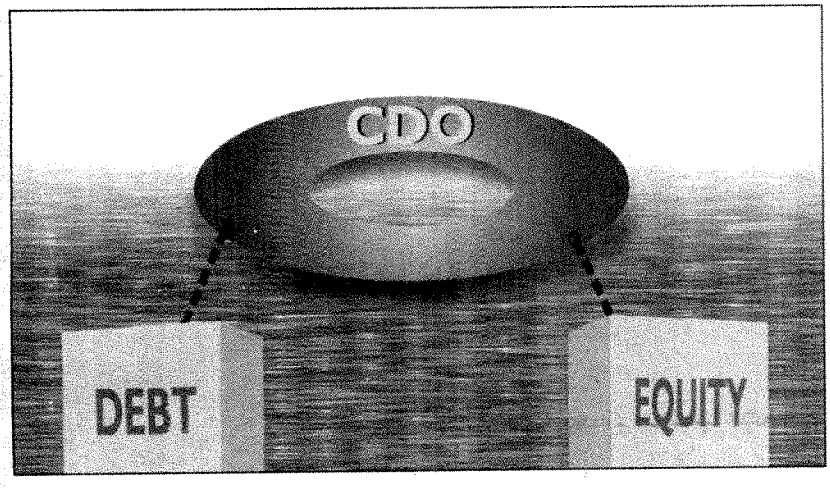
Ramakrishna Neti

Reference # 1-2003-06-04

COLLATERALIZED DEBT OBLIGATIONS

Collateral fear

A slew of rating downgrades and rising corporate defaults worldwide threaten to inflict collateral damage on CDOs. Will they survive?



"The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen)," so said Warrant Buffett in his investment firm Berkshire Hathaway's 2002 annual report. The world's most successful investor's angst towards derivatives has only increased in recent times as he finds it very difficult to sell the derivatives business—General Re Securities, which he inherited when he acquired General Re a couple of years ago. Both these businesses (derivatives and reinsurance) he compares them to hell as he says, "Like Hell, both are easy to enter and almost impossible to exit" is so much so that he does not even hesitate to call them weapons of mass destruction. The Oracle of Omaha is not alone in the campaign against credit derivatives, a kind of financial instrument used to hedge risk. Alan Greenspan too has, of late, been voicing concern over the state of affairs at the derivatives instruments which comprise Collateralized Debt Obligations (CDOs) among others. The US Fed chief recently observed that despite the ongoing debate over the benefits and costs of derivatives, the performance of the economy and the financial system in recent years does suggest that such benefits have materially exceeded the costs.

No doubt that an unprecedented rise in bankruptcy filings by corporates in the US (and also in Europe and Asia), in the aftermath of Enron, and a series of rating downgrades that have followed afterward, have dented the confidence of investors in derivatives markets. With corporate debt defaults touching record highs (it touched a high of $160 bn globally in 2002), investors worry that all may not be well with the derivatives markets. This apart, another issue that is concerning the investors is the concentration of derivatives market in a handful of few big financial intermediaries. Industry experts worry that the large amounts of credit risk have become concentrated in the hands of relatively few derivatives dealers, who trade extensively among themselves.

Though no one can deny the fact that CDO over the years has emerged as a useful risk management tool, the recent events do suggest that it is time to take a look at some of the apparent flaws that might have appeared in the system and initiate corrective measures to avoid any future catastrophe which could threaten the entire financial system; the world's most revered investor recently remarked that credit derivatives are time bombs, both for the parties involved and the economic system.

The brewing trouble

CDOs, which came into existence in the mid-1990s, emerged as one of the most significant innovations of the securitization market in the 1990s. A CDO is basically a collection of debt securities that may comprise of bonds, loans, revolving credit facilities, structured finance obligations, and almost any other kind of debt obligation. The debt may be foreign or domestic or a combination of both. Also, they may be investment grade or high yield or a combination of both. These loans are sliced and diced into pieces called tranches; generally, they consist of three tranches. The degree of risk varies from tranche to tranche. The tranches are organized so that the losses in interest (or principal) to the collateral are absorbed first by the lowest level tranche and then the next tranche and so on. The mechanism for distributing the losses to the various tranches is called the 'waterfall'. Losses occur when there is some kind of credit event; a credit event is usually either a default of the collateral, or a credit downgrade of the collateral. In either case the market value of the collateral drops. According to Richard Skora, President, Skora & Company, Inc., a credit risk

management consulting firm, CDOs create new, customized asset classes by allowing various investors to share the risk and return of an underlying pool of debt obligations. The attractiveness to investors is determined by the underlying debt and the rules for sharing the risk and return.

In a three-layered CDO, the lowest or equity tranche, popularly known as the 'toxic waste', becomes the first to take a hit in case there is any default by a company in the pool. Next comes mezzanine level. At the top of the layer is the senior tranche which is considered the safest. This comprises of triple rated securities. The senior tranche will suffer only in case of collective failure of the companies in the pool. Collateralized Bond Obligations (CBOs), Collateralized Loan Obligations (CLOs), and Credit-Linked Notes (CLNs) are the three most popular categories of CDOs.

CDOs have become immensely popular among banks and financial intermediaries as a risk management tool. As the transactions are arranged off-balance sheet, they allow issuers like banks and financial intermediaries to sell-off assets and free the capital; as they do not have to reserve as much capital on their balance sheets. The market for CDOs has grown phenomenally ever since they came into existence. From a billion dollar in 1995, the CDO market swelled to $234.5 bn in 2002, according to the US-based Bond Market Association.

During the economic boom in late 1990s banks capitalized on the low default and bankruptcy rates, which were at their historic lows, pushing aggressively the sales of CDOs, offering attractive returns. This lured even less experienced investors to put their money in a nascent yet complex instrument. However, as the markets in recent times have been marred by a surge in bankruptcy cases involving some high-profile bankruptcies like Enron, WorldCom, Global Crossing etc., growing troubles in sectors like telecom, IT, retailing, Internet start-ups, followed by a spate of rating downgrades, have put CDOs under tremendous pressure as they suffered severe downgrades and losses.

CDO Issuance, by Primary Collateral Type – 03/31/2003

	1Q-03 Issuance ($ mn)	No. of Deals	Market Share (%)	1Q-02 Issuance ($ mn)	No. of Deals	Market Share (%)
Structured products	$5,770.0	19	46.2	$4,940.4	13	28.9
Investment-grade corporate bonds	2,020.7	8	16.2	2,577.6	9	15.1
Corporate loans (arbitrage)	1,443.9	6	11.6	3,624.6	10	21.2
Private equity/ hedge-fund shares	1,047.0	2	8.4	0.0	0	0.0
Preferred stock/trust-preferred securities	900.4	2	7.2	1,103.2	2	6.5
Corporate loans (balance sheet)	843.7	3	6.8	1,750.2	7	10.2
High-yield corporate bonds	463.5	1	3.7	2,382.2	7	13.9
REIT unsecured debt	0.0	0	0.0	500.0	1	2.9
Sovereign debt	0.0	0	0.0	216.6	1	1.3
Total	12,489.2	41	100.0	17,094.7	50	100.0

Source: Asset-Backed Alert

With the worldwide economic slowdown extending further and countries across major markets like US and Europe continuing to teeter, there could be more troubles ahead for the CDO markets. Of late, there has been significant rise in corporate bankruptcy cases in America. Within 2001 and 2002 alone some 450 companies filed for bankruptcy in US. The fact that CDO ratings follow the ratings of underlying corporate securities point to the danger ahead if this trend persists for long. In fact, downgrades of investment grade corporate bonds in America reached a record high of 22% in 2002, while bond defaults touched $160 bn globally. The repercussions of this have already been reflected on the CDOs. According to *The Economist*, the equity and mezzanine tranches of many CDOs have suffered severe losses; some have been even wiped out. It says that even senior tranches, usually rated triple A, have been downgraded because losses are yet to reach them. According to Derivatives Strategy, an industry think-tank, the latest round of credit downgrades in Asia and Eastern Europe has proven that even the most carefully designed structures can flounder if markets are stressed enough. It says that last year in August, Moody's Investors Service put 11 hybrid CBO/CLO tranches on credit watch, and downgrades have occurred in emerging-market countries such as Venezuela, Brazil, Ecuador, Romania and Ukraine. While in October, the rating agency downgraded another 15 tranches issued within 12 CBOs, seven tranches of five CBOs remained under review for downgrade. During the same month, the firm announced that it was reviewing possible downgrades for the A1 ratings of three CLOs backed by Bank of Tokyo-Mitsubishi. The think-tank says that it is a sign that the banking crisis in Japan continues to fuel fears of a global economic downturn. The result, the research firm says, is that most CBO and CLO transactions nowadays seem to be as attractive to investors as tainted meat. According to Derivatives Strategy,

CDOs: At a Glance

Collateralized Bond Obligations, Collateralized Loan Obligations and Credit-Linked Notes are collectively called Collateralized Debt Obligations. CDOs inevitably require a bankruptcy-remote special purpose vehicle or limited liability corporation, both of which are designed to separate the performance of the issuing bank from the performance of issued notes. The performance of CDOs, in other words, depends on the performance of the underlying collateral portfolio, not on the performance of the issuing institution. CDOs are issued for a variety of purposes. Some originate as a means to create high-yield debt instruments for certain classes of investors, such as hedge funds. Others are issued primarily to obtain medium-term funding that can be reinvested or loaned at favorable rates. CDOs can be broken down into three general categories: Cash flow, market value and credit-linked notes.

Cash Flow CDOs

In cash flow CDOs, the various tranches of the deal are rated according to the likelihood that cash flows generated by the underlying portfolio of assets will cover investors' principal and scheduled interest payments. In a typical structure, there will be an AAA or AA senior tranche, a BBB or BB mezzanine tranche and an equity tranche. The investment grade tranches are typically overcollateralized. For example, a $500-mn pool of collateral could be divided up into a $300-mn senior tranche, a $150-mn mezzanine tranche and a $50-mn equity tranche. The exact ratios of overcollateralization are determined by the rating agencies' evaluation of the overall credit quality of the underlying portfolio of collateral. Typically, the underlying portfolio composition of cash flow CDOs is relatively fixed according to industry sector, geographical and credit quality concentrations; the overall portfolio must also meet a predetermined weighted average reflecting overall credit quality. For example, an extremely simplified portfolio might include 50% technology debt, 25% financial sector debt and 25% manufacturing debt, distributed across an 80% allocation to the US market and a 20% allocation to the UK market. The typical collateral pool, however, is much more diverse.

Market Value CDOs

Although market value CDOs are similar in structure to cash flow CDOs, there are striking differences in how the underlying pool of collateral assets is managed. These instruments are called market value CDOs because the market value of the underlying portfolio of traded instruments determines the level of low-risk collateral that must be held to protect senior tranche investors. Essentially, the collateral pool underlying market value CDOs behaves like a margin account. Assets are dynamically reallocated between a trading account and a risk-free holding account designed to protect senior bondholders. When the market value of the underlying pool of collateral drops to unfavorable levels, the portfolio manager must respond to a 'margin call' by liquidating assets from the trading account and transferring the value to a holding account to protect the senior bondholders from losses.

Credit-Linked Notes

It is not necessary to set up a special purpose vehicle to get the benefits of a CDO. Issuers looking to move risk off their balance sheets can mimic the behavior of common cash flow CDOs with credit derivatives. Instead of transferring assets from the issuer's balance sheet to an SPV, issuers can use a credit-linked note to shift the risk associated with a portfolio of assets to the SPV while the assets themselves remain on the issuer's balance sheet.

The standard instrument used for this purpose is a default swap, a transaction in which the issuer pays the SPV a premium in return for contingent payments should one or more credits in the reference portfolio default. The reference portfolio is designed to mirror the mix of assets on the issuer's balance sheet. Once the risk has been transferred to the SPV, it can issue notes to seek new funding for reinvestment or to support the issuing bank's lending and other business activities.

Source: Derivative Strategy.com

even transactions driven by portfolios composed of high-quality credits have become difficult to place in this jittery market. Two major Japanese CLOs—a $2.25-bn deal from Bank of Tokyo Mitsubishi and a $1.7-bn deal from Dai-Ichi Kangyo Bank—have been indefinitely postponed, even though both transactions involved the securitization of high-quality US corporate loans, it says.

However, Vinod Kothari, securitization expert and author of the book, *Securitization, Asset Reconstruction & Enforcement of Security Interests*, creditderivatives.com does not fully agree with the currently prevailing mood against CDOs. He argues, "Investors, of course, are concerned about the increasing downgrades, and the high rates of default seen in the CDO sector over the last few quarters. These concerns are understandable: But the downgrade and default rate are still lower than corporate bonds." He adds that the credit quality of CDOs is based on the quality of the corporate paper that backs the CDO. "The worsening corporate health is a general cause for concern all over the world—and CDO investors can simply not be immune from that," asserts he.

The contagion impact

A more troublesome fact that is concerning analysts is the issue of contagion impact the CDOs could have on the financial markets as a whole. Buffett has been very categorical about this issue while saying that credit derivatives can exacerbate trouble that a corporation has run into for completely unrelated reasons. In the annual report of his firm for 2002, he wrote about the pile-on

effect a derivatives contract could have, which requires that a company suffering from a credit downgrade immediately supplies collateral to counter parties. "Imagine, then, that a company is downgraded because of general adversity and that its derivatives instantly kick in with their requirement, imposing an unexpected and enormous demand for cash collateral on the company. The need to meet this demand can put the company into a liquidity crisis that may, in some cases, trigger more downgrades. It all becomes a spiral that can lead to a corporate meltdown."

Buffett further states that derivatives also create a daisy-chain risk that is akin to the risk run by insurers or reinsurers that layoff much of their business with others. "In both cases, huge receivables from many counter parties tend to build up over time," he says. "Under certain circumstances, though, an exogenous event that causes the receivable from Company A to go bad will also affect those from Company B through Z. History teaches us that a crisis often causes problems to correlate in a manner undreamt of in more tranquil times." He draws a parallel from the banking industry where he says that the recognition of a 'linkage' problem was one of the reasons for the formation of the Federal Reserve System. He says that before the Fed was established, the failure of weak banks had sometimes put sudden and unanticipated liquidity demands on previously strong banks, causing failures. He advocates for an overseeing body, perhaps something on the lines of the Fed, can insulate the strong from the troubles of the weak.

Buffett though agrees with the general view that derivatives reduce systemic problems by enabling market players to transfer risks, thereby helping the economy to stabilize, facilitate trade, and eliminate bumps for individual participants, he is concerned over the macro picture is dangerous and getting more so. "Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another. The troubles of one could quickly infect the others," he writes in the annual report. "Linkage, when it suddenly surfaces, can trigger serious systemic problems," he adds, citing the ill-famed Long-Term Capital Management (LTCM) case. Buffett says that the Fed rescued LTCM from a certain collapse as it feared that the failure of the hedge fund could have a domino effect on the whole financial markets in US.

Industry analysts believe that the key to prosperity of CDO markets would be the increased awareness among investors about the risks related to a CDO investment. Skora suggests that attempts should be made to formulate ways to properly establish correlation coefficient. He says that a CDO is a correlation product and a CDO investor mainly buys correlation risk. To determine that they are getting a fair return for this risk, they must be able to measure the correlation risk. Since the 1950s when Markowitz did his pioneering work on portfolio theory, there has been intense study of correlation between equity investments, however, correlation between debt securities has not been studied so intensely because debt securities other than US treasuries are not liquid and have high transactions costs, suggests Skora.

A study of the development of CDO markets suggest that in the past, spreads were much higher than the historical loss rate on non-investment grade credits. This meant that the spread more than compensated the investor for the additional risk. Thus, CDOs enabled investors to rake in windfall profits, by taking higher credit risks. However, now, the credit spreads have completely reversed. In the last few years, spreads on non-investment grade corporates and emerging markets have been at their historical lows; barely enough to justify the extra credit risk. Skora advises that in order to gain greater acceptance and application, there must be a parallel development in our understanding of defaults and, in particular, correlation. The increased awareness among investors will not just benefit CDOs, but will also find applications across all lines of risk management including all kinds of portfolio risk management and capital allocation, he suggests.

> **"It is true that financial assets in general today exceed real assets—that excess has to be a toxic waste. So we either go for a fundamental review of our financial system as a whole, or we cannot single out CDOs as a toxic waste."**
>
> **Vinod Kothari**
> *CEO*
> *Creditderivatives.com*

True, there is hardly any doubt that there should be increased emphasis on educating investors about the risks involved in derivatives investments and on developing methodologies to better estimate such risks.

CDO – Will it survive?

There is no doubt that CDOs, besides being useful as a tool to mitigate risk, provide a way to raise capital for non-investment grade borrowers. For investors too they offer a way to earn higher yields by incurring a little extra risk. However, as the recent cases of corporate scandals demonstrate,

these tools have been abused more, rather than used for genuine risk management purposes, by greedy corporates to inflate their earnings numbers, using (abusing) the mark-to-market method; Buffett calls it mark-to-myth method. As the Enron's case suggests, these tools were deployed to create fictitious revenues, which never existed. To quote from Warren Buffett's address to shareholders in 2002 annual report of Berkshire Hathaway, "In the energy and utility sectors, companies used derivatives and trading activities to report great 'earnings'—until the roof fell in when they actually tried to convert the derivatives-related receivables on their balance sheets into cash." Companies like American Express Financial Advisors, Conseco, and several other institutional investors have all, in recent times, had the taste of the toxic waste from CDOs written four to five years ago. Maybe, there would be some more losers in the pipeline.

Whether the current environment of gloom signals the end of the road for CDOs?

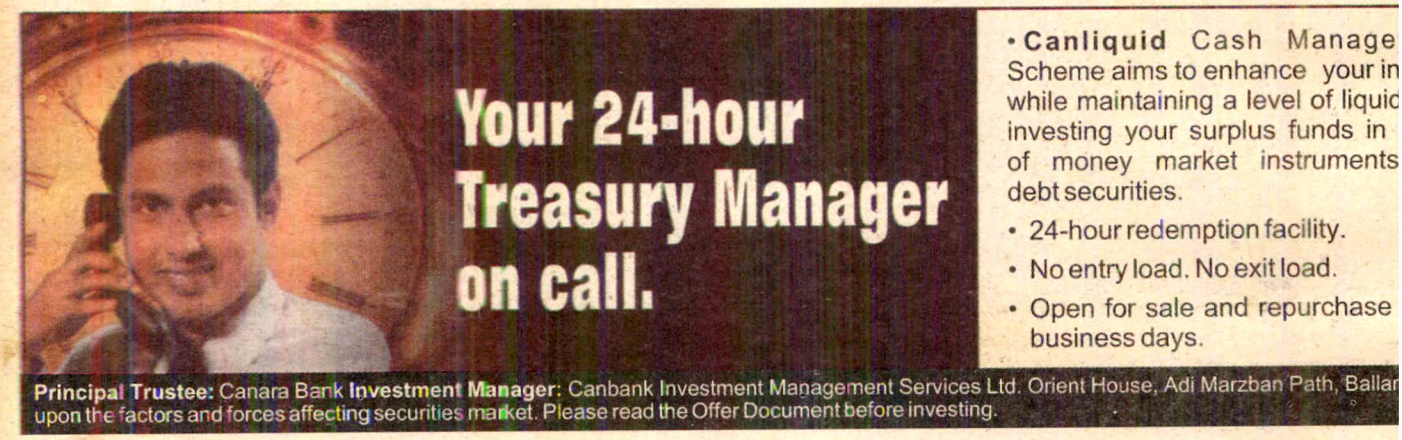
The current pessimism could be because of over-reactions from the investors, as suggested by a section of experts. They point to the fact that only a handful of developed-market CBOs and CLOs have been downgraded or shutdown over the past few years, and those losses were primarily absorbed by the investors holding unsecured instruments of high-risk tranches. They also suggest that the comparisons of the problems associated with CDOs and those associated with mortgage-backed securities may also be unfair. Mortgage-backed securities were sold to a wide variety of fixed-income investors and frequently to investors who didn't understand what they were buying. "The CDO market is affected by worsening corporate health and has nothing to do with a shifting prepayment rate," reckons Kothari. According to industry analysts, CDO investors taking the hits today are hedge funds, proprietary money managers and other market experts who are well aware of the risks and returns of such instruments. However, this logic may not be enough to satisfy critics who cite LTCM's example, which got into trouble despite being run by two noble laureates, to justify their growing concern over hedge fund' so-called sophistication.

To alert investors, Kothari advises that apart from the asset class, CDO investors must carefully investigate the sources of subordinated capital. Quite often, he says, the subordinated investors are those very obligors whose loans/bonds are acquired by the CDO. Credit enhancement has no meaning if it comes from the borrower—because it is no enhancement but merely cutting down the size of lending. So, it is important for the investors to understand who are the equity investors? What are their motivations? The equity investors must have real money at stake. He has a suggestion for investors—"It is important to understand that the external investors' comfort is only to the extent of discomfort of the equity investors."

However, apart from investors, regulators too have to be cautious and agile. As Warren Buffett remarked in the annual report 2002 of his investment firm, "The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Knowledge of how dangerous they are has already permeated the electricity and gas businesses, in which the eruption of major troubles caused the use of derivatives to diminish dramatically. Elsewhere, however, the derivatives business continues to expand unchecked." Certainly the regulators have to find ways to keep a check on the genie's abuse by the masters of chicanery or else there is danger that any future collateral damage could shut the doors of growth for this wonderful financial instrument called CDO.

Amit Singh Sisodiya

Reference # 1-2003-06-05



SALES TAX REFORMS

Perils of procrastination

Aimed at rationalizing the complicated tax structure of India, the implementation of VAT is yet again delayed. Though the states have agreed to implement VAT beginning from April 1, 2003, certain issues that hold the key to success still remain unaddressed.

Termed as "A historic reform of our domestic trade tax system" by the Union Finance Minister during the 2003-04 budget speech, the highly debated Value Added Tax (VAT) implementation has been yet again deferred. The empowered committee on VAT comprising of state finance ministers has decided to breach the deadline. Continuing the saga of postponement ever since April 1, 2000, VAT has been postponed for the fourth time in a row. The postponement undermines one important aspect—Indian tax system is not only complicated but any reforms for the same are also complicated.

The saga of postponement

For one reason or the other, the implementation of VAT was always deferred. In 2001 and 2002, it appeared that the implementation is going to materialize. However, the states under the pretext of uncompleted formalities have requested the Central Government to defer the implementation. First, it was about the loss of tax revenues by the states that has prompted the Center to postpone the deadline by one year. Central Sales Tax (CST) is an important component in the revenue generation exercise of many industrialized states. It was feared that once VAT is implemented, CST has to be abolished resulting in a negative impact on the tax revenues of states. At that point of time, the Center had assured states compensation for any revenue loss incurred as a result of VAT implementation and abolishment of CST.

It was calculated that the revenue loss to states as a result of migration to VAT would be around Rs. 12,000 cr annually. The Central Government has agreed to provide 75% compensation in the first year (around Rs. 9,000 cr), 50% in the second year (around Rs. 6,000 cr) and 25% in the third year (Rs. 3,000 cr). Following a series of negotiations between the Center and State Government, the way for implementing VAT beginning from April 1, 2002 was finally cleared.

However, on the scheduled date in 2002, it was once again announced that implementation was deferred by one more year. Though almost all the states and union territories have in principle agreed for VAT implementation from April 1, 2002, only 12 states were operationally prepared for the new tax regime. The states were asked to draft VAT proposals independently so that a unification of the proposals can be done at a later stage. Though some of the states have completed framing the proposals, others were yet to complete their drafting on schedule. This has led to the postponement once again.

Though it appears that the states are geared up for the implementation of VAT, postponement still seems to daunt VAT. At the beginning of the year, a member of the Empowered Committee claimed, "The likelihood of VAT being introduced in the country is high this year. Barring a few issues, like fixing revenue neutral rate, classifying products under different slabs, there is a broad consensus amongst most state governments on all points." In fact, some of the state governments like Maharashtra and Madhya Pradesh initiated deliberations on VAT in their legislative assemblies to meet the scheduled deadline.

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This has resulted in optimism about implementation among corporate and industry bodies.

Why again?

In spite of the optimism that was prevailing at the beginning of the year, the agenda of reforming Indian sales tax system was again delayed. What is the reason for the delay? What are the major reasons that propelled the empowered committee to breach the deadline? How different was the scenario compared to the previous year? What issues still need to be clarified before the actual implementation of VAT?

Though the switch-over to VAT looks imminent, what is actually being proposed to be taken up is the rationalization of sales tax system. Initially, a hybrid form of VAT will replace sales tax that will co-exist with excise, customs, entry tax and CST. This is the actual bone of contention. Commenting on the intentions behind the rationalization of tax system, Dr. Govinda Rao, Director, Institute of Social and Economic Change, says, "First of all, despite all claims, what was proposed to be implemented from April 1 was not VAT, but a significant rationalization reform towards achieving VAT. The reform would have reduced the number of tax rates, broadened the base by extending the tax to stages beyond first point, reduced the tax inter-state tax rate differences and harmonized the tax system among the states, provided for the relief of tax paid at previous stages and reduced the burden of inter-state tax exportation." However, industry sources believe that co-existence of VAT and indirect taxes may lead to a higher tax burden on the companies. Companies in turn will be prompted to pass on this extra burden on the consumers. In order to reduce the tax burden and further complications, industry bodies are favoring the introduction of pure VAT. The challenge for the government lies in enabling the movement from hybrid VAT to pure VAT while maintaining the tax rates affordable for the business community and consumers.

In order to clear this first hurdle, the Empowered Committee recommended the abolition of CST over a four-year period. In the first year i.e., 2003-04, CST will remain at the current rate of 4%. However, rate will be reduced to 2% in second year and 1% in the third year. In the fourth year, there will be no CST. While the industry body welcomed the proposal, the state governments did not agree with the Empowered Committee as this may lead to a substantial loss in revenue for them. It is only after the Central Government promised 100% compensation for the revenue loss, the state governments accepted the proposal of the committee.

The challenge for the government lies in enabling the movement from hybrid VAT to pure VAT while maintaining the tax rates affordable

Apart from the fears of the revenue losses, there is also a political angle to the saga. Dr. Rao, feels, "The reason for the postponement of reform is that the lack of political will. The traders are an important special interest group. Many of them, particularly in places like Delhi have not been used to paying the tax and with the introduction of reform, the tax has to be paid." He further explains, "In Delhi traders are an important lobby, and they have never had the culture of paying the tax. Given that Delhi has been having a predominantly last point tax, once you escape that point you have evaded the tax successfully. Now if you have to pay the tax, it will pinch. Given that the traders have important political clout, this becomes easy."

As is the case with the previous year, there was certainly no clarity among the consumers about VAT. This has resulted in widespread agitations in some states—the end result being that the state governments succumbed to public pressure. "A part of the reason is also the lack of clarification by the authorities that the introduction of reform will not result in the greater interface between the taxpayers and officials. Unfortunately, education and publicity have not been taken seriously," identifies Dr. Rao. Another major factor that drove the postponement decision is the readiness of the state governments. Though the states had announced their readiness to implement hybrid form from the beginning of the current fiscal, the ground reality was that they were not yet ready. With regard to the preparedness for full-fledged VAT implementation, Dr. Rao says, "As far as full-fledged VAT is concerned, we need to build the information system on inter-state transactions for zero-rating them and that it would take two-three years. Other conceptual issues need to be resolved and there must be a publicity and educational campaign separately for traders, manufacturers and consumers."

What it means to businesses and consumers?

The rationalization of sales tax system will no doubt, have profound impact on the businesses. In its most basic form, the tax liability under the new structure will be calculated on the gross income i.e., the difference between the total value of the purchase invoices and sales invoices without any consideration to the operational expenses incurred during the process. Additionally, under the new system, the paperwork involved is going to increase manifold. Every taxpayer has to make personal visits to the sales tax office every month or quarter to get

duly assessed by physically showing purchase and sales invoices. In case of companies with turnover more than Rs. 40 lakh, it is mandatory to have a financial audit by a chartered accountant. In order to identify the companies on a national basis, each company will be given a unique 10-digit alphanumeric taxpayer identification number. This will facilitate the transfer of inter-state data. While the first two letters denote the state of registration of the company, the remaining digits denote the serial number. Experts feel that since there will be a tax on every sale, unhealthy business practices like circular trading will automatically get discouraged.

Another important aspect pertaining to businesses is the multiplicity of tax levying points. Under the current system, sales tax is a single-point tax—levied at the time of sale. However, as VAT is a multi-point tax, trade margins at every stage will be taxed. And in some cases, it is observed that the proposed rates of 10% and 12.5% are higher than the prevailing sales tax rates.

One section that is not aware of the objectives and concepts is consumers. While there have been extensive debates over the implementation of VAT between the government and industry bodies, consumers are in a total dilemma over the benefits of VAT. Dr. Rao agrees about the plight of the consumers. He says, "I don't think anyone cares for the consumers yet. This is seen from the fact that neither the decision to implement VAT nor its postponement has taken any input from them."

Emerging out of misconceptions prevailing among the general public about VAT implementation is a fear of rising prices. Going by the international experience, many of the countries witnessed a sharp rise in inflation levels immediately after the VAT implementation as a result of rise in prices of majority of goods (Refer table). As the proposed structure will have both CST and VAT operating together, in the immediate future, there may be an increase in the end-user prices. Commenting on the fears of rise in inflation, Dr. Rao says, "Such views are common. Some commodity prices may increase and others may fall. The ultimate effect on price index depends on the composition of consumption. The price implications of VAT need to be worked out carefully and if someone tries to provide answers to this even before the introduction, he must be GOD." However, he also feels that the inflation levels can be maintained when he says, "The removal of tax on tax, mark-up on tax and tax on mark-ups tends to reduce the inflation element. Similarly, tax relief on inputs and capital goods will tend to dampen prices. The overall effect therefore, depends on the tax rate chosen. Besides, transition from the prevailing multiple rates involves increasing rates on some commodities and reducing on others. The ultimate price impact depends on these factors."

Price Changes in VAT Implemented Countries

Country	Month of VAT Introduction	Immediate Change in Prices (in %)
Argentina	January 1975	57.2
Bolivia	October 1973	9.5
Brazil	January 1967	15.8
Chile	March 1975	146.7
Columbia	January 1975	12.9
Denmark	July 1967	8.0
France	January 1968	2.1
Ireland	November 1972	5.5
Israel	July 1972	17.9
Italy	January 1973	6.3
The Netherlands	January 1969	5.2
Norway	January 1970	7.8
United Kingdom	April 1973	4.9
Uruguay	January 1968	66.3

* The figures are sourced from IMF reports as well as country reports circulated by the Confederation of Indian Industry.

Source: Rediff.com

The road ahead

No one can deny the fact that the proposed VAT will eliminate the complexities in the sales tax laws and attempt to bring about simplicity. But, if the implementation of the same is done with addressing the issues, then it may lead to a totally chaotic situation. In order to ensure smooth transition, the government and the Empowered Committee should realize the importance of educating the people, business and other concerned parties. Dr. Rao, suggests, "The first thing the government should do is to launch a wide publicity campaign with a booklet on demystifying the myths about VAT. In fact, the proposed structure is supposed to be taxpayer-friendly and how it should be demonstrated. It is important to show, how the small traders do not have to worry about detailed book-keeping, how there will not be an interface between taxpayers and officials etc., should be addressed. For the consumers, the issues that need to be told are—will VAT increase prices? What are its advantages and what are the problems that need to be clarified."

Taking a cue from the international experience, it is high time that India embraces a transparent taxation system. It is in the interests of the economy and business, in particular, the speedy implementation of VAT is imperative. Though the efforts of some states, which are proactive in this respect, are laudable, they have to go a long way and lead from front. Until this is done on a priority basis, the results of economic reforms may not bear fruit.

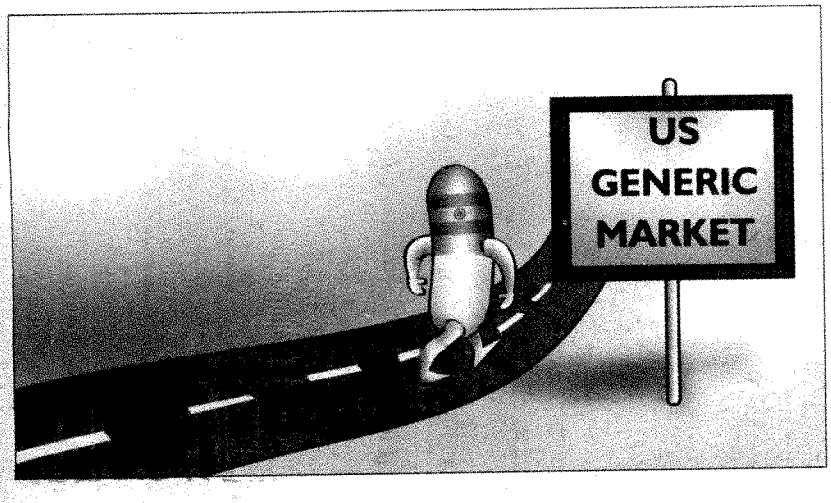
Y Chandra Sekhar

Reference # 1-2003-06-06

INDIAN PHARMA COMPANIES

Doctors' day out

Indian pharmaceutical companies are making headway into the US generic drug market. Will they be able to bank on this experience to develop new drugs?



Indian pharmaceutical companies have discovered an elixir to make money. While the impending product patents that come into vogue from 2005 pose a serious threat to their businesses in India, they are making big money in the US markets. Post-2005, once product patents come into force Indian companies can no longer copy drugs made by big pharmaceutical companies, which in turn will be eager to launch more of its newer drugs in India. K Sumesh Reddy, Consultant, Intellectual Property Rights, and In-House Trainer, Dr Reddy's Labs commented in *Business Today*: "With 2005 round the corner, there is no way out for Indian companies but to discover new molecules. Those who don't will not survive." For more than three decades the Government refused to recognize product patents on drugs and has protected Indian companies. This encouraged companies to copy medicines patented abroad and this if not anything else, honed their skills at reverse engineering. Now that the days of protection are coming to an end, to survive, they have to innovate.

Many companies have now begun to pump money into R&D activities. Companies like Dr. Reddy's Laboratories (Dr. Reddy's), Ranbaxy, Wockhardt, and Lupin Laboratories realized that they have to invest in new drug discovery to gear up for the competition from bigger players. In the mid-1990s, they started investing in research labs to manufacture drugs worthy of patent protection in markets like the US. But this is not going to be an easy task considering the size of investments that are required to develop a new drug. For example, Ranbaxy, India's largest domestic company clocked sales of around $750 mn in 2002. This is a miniscule amount compared to Pfizer's R&D budget of more than $5 bn for 2002. For many companies in India, taking the molecules they discovered through all the stages of trials remains a distant dream.

In such a scenario, it makes sense for these companies to operate a step below drug discovery. What they have mastered all these years in India is coming handy to them now. Large number of drugs belonging to major drug companies in the US are going off patent in the next five years. The market for these drugs is estimated to be worth $80-90 bn and presents a huge opportunity for companies to generate cash that they can use in new drug recovery process. Commenting on the strength of Indian companies, Dr. Appaji P V, Director, National Pharmaceutical Pricing Authority says, "There is good chance of Indian companies capturing big share of American generic market due to strong technical expertise available in India and having already reached the level of American current Good Manufacturing Practice (cGMP) requirements."

Dynamics of the generic markets in the US

In the US, cost of healthcare has been steadily increasing, putting pressure on the healthcare departments. The high prices that drug companies charged for the branded drugs is a major contributor to the increased costs. The search for a solution has shifted the focus on the generic versions of the drugs. In the US, a generic pharmaceuticals company seeking to market a product equivalent to the original product uses the Abbreviated New Drug Application (ANDA) process for seeking marketing approval from the Food and Drug Administration (FDA). This usually happens after the expiry of patent. The generic drug manufacturer relies on the safety and efficacy data developed by the original product innovator during clinical trials. The generic manufacturer has then to prove to

the FDA that the generic version of the original product is equivalent to the branded pharmaceutical.

The time and cost of the entire process is much lesser than that incurred in a new drug discovery. While original molecule takes approximately 12 years to be approved by the FDA, the generic drug takes approximately three years for development to complete and be approved by the FDA. Fueled by the expiration of market exclusivity for large number of products that were available for generic competition, the generic pharmaceutical industry experienced tremendous growth and is expected to touch $45 bn by 2005. In its research report on emerging opportunities for the Indian pharmaceutical companies in the US generics market, Credit Suisse First Boston (Hong Kong) Ltd. (CSFB) said the drugs going off patent were resulting in huge market potential for the generic drugs over 2000-05 and considers the immediate opportunity to be larger than at any time in the history of pharmaceutical industry.

India's advantage

Though it is relatively easy for companies to obtain permission for making generic versions of off patent drugs, the returns on these drugs come down with every new competitor who arrives into the market. According to industry estimates the prices drop to 35% with the first entrant and as the third player enters the generic business with the similar formulation the prices drop to 70-90%. For example refer the data given below.

This implies that only cost-effective supplier has the chances of making it big in the market. It is here that the Indian companies score over competition. They enjoy a distinct advantage of lower labor costs that are only 7-8% of sales as compared to 18-20% for the global players. For example, in India a chemist with a Ph.D. can be hired for $15,000, versus $100,000 in the US. Also manufacturing costs are 45% lower than those of generic manufacturers in the West and infrastructure costs are 40% less. According to CSFB, several Indian pharmaceutical companies have competitive positioning in the US generics market. Their strength in terms of strong process-chemistry skills, good manufacturing capabilities and low-cost manufacturing is helping them to make strides in the US generics market. The report mentioned: "Indian companies have access to a highly talented pool of chemists and scientists, which has helped them to develop strong process-chemistry skills. Since India recognizes only process patents, Indian companies have invested significant resources in reverse engineering of patented molecules." But Dr. Appaji feels that Indian companies can do better by acquiring new capabilities. He suggests that Indian companies should "study in depth the American market structure and develop good networking with strong financial back-up to meet the huge initial costs."

Big Indian companies like Ranbaxy, Cipla, Dr. Reddy's Laboratories, Sun Pharma, Wockhardt, Lupin are investing a lot of money into the generic market and have plans to file for four to five ANDAs every year. So far Ranbaxy and Dr. Reddy's have been the most successful Indian companies in the US generics market. CSFB mentioned that Ranbaxy and Dr. Reddy's as the best-positioned Indian companies in the US generic drugs industry.

Ranbaxy has a strong presence in the US market and operates through two 100% owned subsidiaries Ohm Labs and Ranbaxy Pharmaceuticals. Also it has a 50% partnership with Schein in Ranbaxy Schein, a marketing partnership with Barr Laboratories and a co-marketing arrangement with Purepac Pharmaceuticals for the antibiotic, Amoxicillin. In the US, Ranbaxy broke even for the first time in 2000 and the company generates nearly 40% of its sales from the US markets. In the case of Dr. Reddy's, US revenues in the year ending March 2002 matched those of India's for the first time.

While Ranbaxy and Dr. Reddy's have received a number of ANDA approvals, other companies are not behind. They have started to understand the intricacies of the regulatory framework for ANDA approvals. CSFB report mentioned that though it would take some time for them to establish themselves, they remain to be serious contenders in the market. From being producers of broad-range generics, Indian companies have moved into a position where they can challenge the US patent law to gain exclusivity.

But this has not been an easy task. CSFB says that the critical success factor in the US generics industry is the understanding of the highly regulated nature of the US market. This requires companies to have high level of regulatory skills that involves knowing what goes into the approval process and mastering the art of ensuring faster ANDA approvals. In cases where generic companies want to target existing patent holder with a new process for a patented drug, litigation becomes inevitable. Sometimes investments in these litigations can be as much as $15-18 mn for a drug. But if successful, companies are entitled for exclusive

Drug	Patent holder	Value before going off patent	Patent expired	Price drop in First year	Price drop in Second year
Ranitidine	Glaxo Wellcome	$3 bn	1997	75%	95%
Diltiazem	Aventis	$1 bn	Oct. 92	80%	90%

Source: Businessworld, April 10, 2000.

marketing rights for a period of six months and can thereby recover their investments. On the other hand, companies can avoid litigation by filing for drugs already gone off patent, but the downside of this strategy is the intense competition and as a result lower margins for companies.

Legal battles

Instead of waiting for the branded companies to file for extension of their patents, generic drug makers are aggressively examining patents of blockbuster drugs, most of them for which the patents, offered protection for years to come, to look out for any anomalies and loopholes and exploit them. Big drug companies usually prolonged their exclusive hold over blockbuster drugs in their stable by filing a range of additional patents covering everything from a drug's color to its coating. For generic makers to launch a competing drug, they either had to wait for the patents to expire or fight through these obstacles in the court. G V Prasad, CEO of Dr. Reddy's commented in the *Far Eastern Economic Review*, "This is the only way the business is played in the US. Suing and being sued are a necessary cost of doing business." Before getting a foothold in the US markets, Dr. Reddy's burned money for a number of years fighting court battles with companies much larger than its size without any returns. Dr. Reddy's first tasted success when in 2001 it won the rights to market a special 40-milligram dose for six months after a successful court case against Eli Lilly. The case cost nearly $1 mn but the firm made profits to the tune of $70 mn in a six-month period.

Even Ranbaxy's management had to face criticism for investing in US operations without any returns. All that began to change when the company got the approval for marketing generic version of GlaxoSmithKline's Ceftin. The company is now generating 40% of its turnover from this drug. But this was possible only after a long-drawn battle with GlaxoSmithKline that challenged the effectiveness of the generic version of its drug.

In December 2002, Dr. Reddy's won a case against Pfizer, that allows it to sell an identical drug to that of Pfizer's blockbuster blood pressure drug Norvasc estimated to be worth $3.8 bn in annual sales. This is seen as the firm's first step into the potentially lucrative 'branded generic' segment of the US market, where there is not much competition and at the same time margins are high.

Still, it is a long way to go for the Indian companies who are nowhere near the bigger western pharmaceutical companies especially when it comes to matching them in their ability to develop new drugs. But as India's companies become more successful selling low-cost generic drugs and ingredients overseas, they have a chance to reach and establish themselves at the top of the value chain.

Phani Madhav

Reference # 1-2003-06-07

Details of a Typical Drug Discovery and Development Process

Drug Discovery

Period: Up to six years

Cost: Roughly $60 mn

Odds of drug reaching market: 1:10,000

Identifying and Validating Targets: This involves developing the concept of how a new drug can treat a disease. Compounds that should be pursued further are shortlisted.

Screening: Compounds that have desirable potencies and that react encouragingly are pulled out. These are the 'Hits'. Converting Hits into 'Leads' calls for further refinement in the compound, during which solubility, toxicity (quantity of safe doses), absorption, metabolism etc., are tested, even as the potency and activity are maintained.

Drug Development

Period: Up to 12 years

Cost: Up to $200-250 mn

Odds of drug reaching market: 1:200

Pre-clinical Trials: Toxicity and pharmacokinetics (absorption, distribution, metabolism, elimination) are observed via tests in labs and in animals.

Ind Filing: Company files an application for an investigational new drug (IND) with the FDA. This filing includes results of pre-clinical trials and the plan for human clinical trials.

Phase I Trials: Conducted on 20-100 healthy volunteers to prove safety. Once molecule enters clinical trials, odds of success drop to 1:5.

Phase II Trials: 100-300 persons suffering from the disease are treated. Considered by many companies as the stage to opt for licensing agreement.

Phase III Trials: Involves between 1,000 and 5,000 patients in a bid to verify previous trials.

New Drug Approval Filing: FDA reviews information, and if satisfied gives its approval. If it feels molecule isn't yet ready for market, may call for phase IV trials.

Post-marketing Surveys: Companies have to conduct continuous surveillance once drug hits market, all through the life of the drug. Serious reactions can result in drug withdrawal. Sales and marketing costs can take the entire cost of exercise right from drug discovery to development to as much as $450 mn.

Source: Business Today, October 13, 2002

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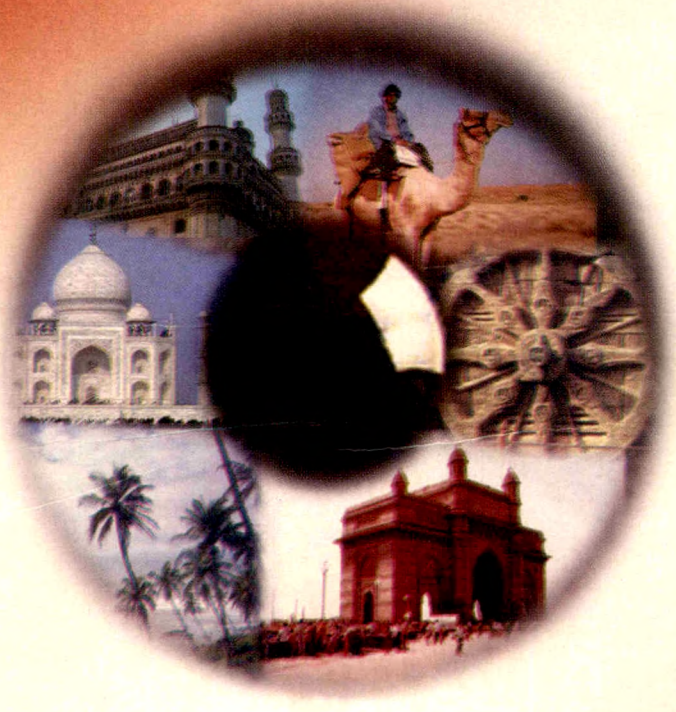
ANALYST



Survey of Indian Tourism Industry

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Survey of Indian Tourism Industry

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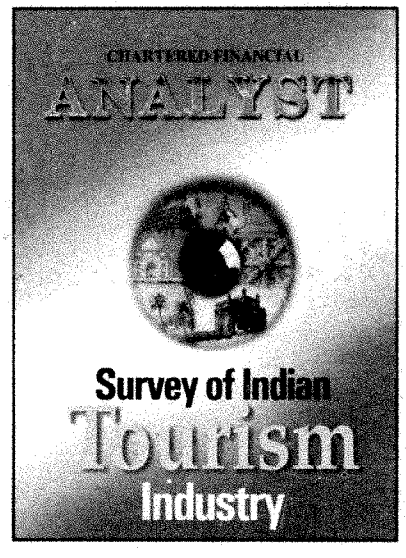

Cover design by A Bangaru Babu

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The views expressed herein are those of the authors and do not necessarily reflect the viewpoint of the organizations with which they are associated.

Tourism Industry: Future Perfect

For many major economies of the world, tourism is an integral part and is an important source of foreign exchange. Apart from being one of the leading revenue-generating sectors, it is also an excellent generator of employment because of its labor-intensive nature. In 2002 alone, the tourism sector is believed to generate around $3.3 tn of GDP and 200 million jobs for the global economy. As per the estimations of World Travel and Tourism Council, the number of world travelers per annum is over 616 million and the spending made by them is over $444 bn. By 2010, the number of world travelers will go up to 1,600 million. It is estimated that one-third of this can be directly attributed to the sector while the rest will come from the strong linkages with other sectors such as entertainment, retail and construction. As per the data of World Tourism Organization, every 9th person is engaged in travel and tourism industry for livelihood.

The level of tourism activity depends to a large extent on the economic development or economic conditions of a country. In case of India, as a result of steady economic growth achieved in the last decade, a pool of affluent middle class was created. This pool is driving the activity in the sector in terms of both domestic and international tourism. Though at present only 0.4% of the Indian population opt for international tourism, the figures may shoot up with the rising income levels. Though India ranks 44th in the top 60 tourism destinations of the world, international tourism has contributed substantially in terms of foreign exchange earnings. In the year 1999-2000, tourism was the second largest foreign exchange earner for the country with over Rs. 12,000 cr of earnings.

With the increasing demand for Indian tourism destinations among the world travelers and affluent domestic middle class, the tourism industry is poised for an exponential growth in the coming years. In line with the global trends—10.6% of world's workforce is engaged in travel and tourism. Tourism supports 9.3 million jobs in India and this number is likely to increase to 12.9 million by 2010. This translates into the fact that out of every 15 employment opportunities created in India, one will be from travel and tourism sector.

Recognizing the importance of tourism in the economy development, all the states have started promoting their tourism destinations independently. At the same time, the states are collaborating with each other to promote India under the concept – 'Destination India'. The various initiatives taken up by some leading states like Kerala, Rajasthan, Tamil Nadu, Goa, Maharashtra and Jammu & Kashmir will go a long way in tapping the huge market. The domestic market with an estimated 240 million tourists per annum (140 million general tourists and 100 million religious tourists) with over Rs. 95,000 cr spending will undoubtedly contribute to the economic development of the country. The huge market size of the industry itself confirms its future growth.

Y Chandra Sekhar
Survey Editor

Indian Tourism

Gaining Momentum

SUBHASH GOYAL
Chairman
Stic Travels Pvt. Ltd.

Though India has not been able to promote its tourist destinations in the past, recent trends indicate a growing recognition globally. If India can implement its strategies as planned, it may compete successfully with the global competitors.

The tourism industry is directly related to the economic and political conditions of a country. In the Indian context, the recent trends indicate a huge increase in the number of visitors. Following the war on Iraq and SARS, the Indian passengers generally going to the Far East and South-East Asia have started preferring the domestic destinations (from South to North and North to South). Also, those who are still keen on a foreign trip have started looking for lesser known but attractive tourist spots in Europe.

Initiatives taken

The overall growth of the industry depends on various initiatives taken up by the Government and other related parties. As one of the representatives of the tourism industry, I have successfully pleaded for the restoration of the LTC that is Leave Travel Concession facility for government servants. (As provided for in the new budget). This step is bound to promote domestic tourism, which is going to be our mainstay, at least for some time to come.

I am now lobbying with the concerned authorities for the abolition of the service tax for travel agents and tour operators. If the same can be withdrawn in case of hoteliers, why not for us?

I am also working for the reduction in ATF, which makes air travel within the country costlier than such foreign destinations as Hong Kong, Singapore, Bangkok, Malaysia etc.

As Chairman of the Stic Travels, I have taken steps to promote domestic tourism by devising special religious tours for Hindus, Muslims, Sikhs, Jains, Christians and followers of Saibaba. Some of our packages cover such destinations as Haridwar, Rishikesh, Goa, Garhwal and the Himalayas.

Besides, I have also developed special honeymoon packages covering such destinations as Simla, Kurfi and Kullu Manali, Mt. Abu, Nainital, Corbett Park and North East. We have also some of the best packages for the more adventurous couples.

Stic Travels is the one-stop shop where we meet all the requirements of the passengers from A to Z. We also do our business at the minimum margin of profit. We offer the best prices on air ticketing, hotel reservations, cars and bus rentals, package tours, foreign exchange and international cards.

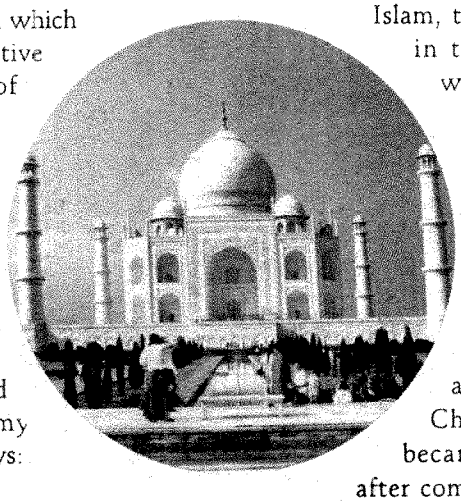
We have installed the most ultra modern computer reservation systems. We do all the global reservations for airlines and hotels through Abacus & Amadeus and World Span. We can also provide our customers with complete information on weather conditions in any part of the world. Our customers can buy from our office complex theater tickets for most of the world destinations.

Issues to be addressed

It is a matter of concern for us in the industry that while China and India started promoting their tourism almost at the same time, China (if

the visitors to Hong Kong are also included) has crossed the 50 million mark, India has been still stuck up to poor 2.4 million level (which is shameful!).

What is most important is to have commitment, which can help us solve all issues relating to tourism and aviation. We need to have a tourism board. We must also have an action plan which may become operative within 10 days of any crisis—be it Wars or SARS.



Some other issues that hamper tourism growth in India and therefore need to be addressed immediately, to my mind, are as follows:

- Visa on arrival.
- Rationalization of taxes.
- One Window Clearance.
- Improvement in communications and infrastructure.
- More international airports and their linkage with important cities.
- More hotels and hotel rooms.

Outlook

If all the states start promoting themselves, we can easily achieve a target of 9 million arrivals in the next three to four years. This program needs to be coordinated with civil aviation ministry. India being the greatest show on earth, the future of tourism has been and will be bright provided we play our cards well. India is the birthplace of four great religions: Hinduism, Buddhism, Sikhism and Jainism. Islam, though originated in the Middle East, when touched the shores of India, gave rise to Sufism and led to the development of some of the most beautiful Islamic architecture. Christianity also became more mystic after coming to India. In fact one of the 12 disciples of Jesus Christ is buried in the church of Saint Thomas at Chennai. India also has one of the Seven Wonders of the World 'The Taj Mahal'.

If we keep these factors in mind, the day is not far when the country can compete successfully with the arrival figures of the neighboring South-East Asian countries.■

India being the greatest show on earth, the future of tourism has been and will be bright provided we play our cards well

International Tourist Arrivals by Region (millions)

	Base Year	Forecasts		Average Annual Growth Rate (%)	Market Share (%)	
	1995	2010	2020	1995-2020	1995	2020
Total	**565.4**	**1006.4**	**1561.1**	**4.1**	**100**	**100**
Africa	20.2	47.0	77.3	5.5	3.6	5.0
Americas	108.9	190.4	282.3	3.9	19.3	18.1
East Asia/Pacific	81.4	195.2	397.2	6.5	14.4	25.4
Europe	338.4	527.3	717.0	3.0	59.8	45.9
Middle East	12.4	35.9	68.5	7.1	2.2	4.4
South Asia	4.2	10.6	18.8	6.2	0.7	1.2
Intraregional (a)	464.1	790.9	1183.3	3.8	82.1	75.8
Long-Haul (b)	101.3	215.5	377.9	5.4	17.9	24.2

Source: World Tourism Organization (WTO)

Notes:
a. Intraregional includes arrivals where country of origin is not specified
b. Long-Haul is defined as everything except intraregional travel.

Indian Tourism
Driver for Economic Growth?

N JANARDHAN RAO

Tourism has emerged as one of the key economic drivers. The fact that many economies flourished on the strength of tourism activity is indicative of its potential. India is no exception to this, tourism is one of the prime engines of growth.

Tourism is the backbone of any national economic growth. It has its ramifications into almost all sectors and is being influenced by the performance of each of these sectors directly or indirectly. Despite volatility in global politics, tourism worldwide has witnessed sustained growth both in terms of number of tourists and tourism receipts and its contribution to the economies have been manifold over the years. It is one of the fastest growing industries. The industry has always emerged successfully from all difficult situations. There has been a global tourism boom in recent times. This is why countries across the world accord very high importance to tourism promotion. India is no exception, tourism is one of the prime engines of growth.

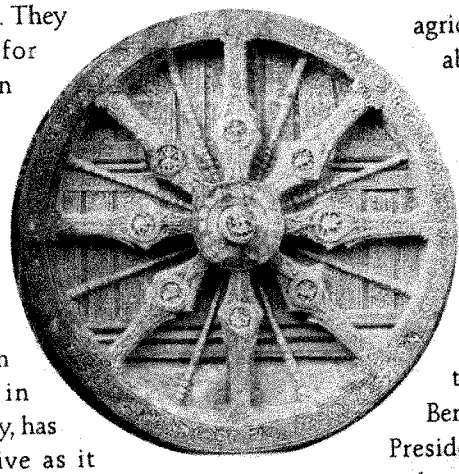
Right from the snowcapped mountain ranges of the Himalayas in the north to the docile backwaters of Kerala in the south, from the sandy beaches of Goa in the west to the variegated wildlife sanctuaries of the northeast, India holds a colorful and priceless bounty for tourists. The industry has emerged as a major segment of the Indian economy, contributing substantially to foreign exchange earnings. However, India's share in international tourism is insignificant considering the size of the country—its share in international tourist arrivals has been a paltry 0.37%. The country's natural and historical wonders have the potential to attract billions of dollars in tourist revenues. Today while more than 27 million international tourists visit China annually, India manages only around one-twelfth of this figure.

There has been a phenomenal growth in domestic tourism in the country during the last one decade. The domestic tourist visits increased from 63.8 million in 1990 to 210 million in 2000. Regarding employment generation, tourism provides enormous opportunities for employment generation. According to an estimate, the travel and tourism industry has directly generated 9.3 million jobs in India. The travel and tourism industry includes activities such as accommodation, transport, catering, entertainment, recreation and other travel-related services. The travel and tourism economy, which expresses the impact of travel and tourism and its flow-through effect across the wider economy, have generated 17.4 million jobs in India. The industry body, Confederation of Indian Industry (CII), has a vision

for tourism in India. It calls it Tourism Vision 2020 i.e., where it visualizes India as a tourist destination by the year 2020. CII expects India to host 40 million foreign tourists by then with the travel and tourism economy contributing Rs. 1 tn. Tourism would be the provider of employment to 50 million people i.e., one out of every eight.

However, the industry is facing plenty of problems which are hampering its growth. Infrastructure still remains the most important impediment in realizing the high potential that the tourism industry holds for India, like inadequate transport facilities such as airline, rail or roadways, lack of basic amenities at tourist centers, and lack of hygiene. Despite a modest growth in the number of rooms available, India still lacks reasonably priced accommodation in comparison to its neighboring countries. Industry leaders have been demanding fiscal sops and tax breaks for the tourism sector for a very long time. They point out that for every dollar spent in India by a tourist, he pays as much as 27% in taxes on an average with figures going up to 35% in states such as West Bengal. This high tax component in room tariff, they say, has been a disincentive as it removes India's competitive advantages. Compared to India's high taxation rates, in other major global destinations the tax burden is only in the range of 4 to 8%. In addition to expenditure tax, which a tourist has to pay, he has to cope with service tax as well which the industry describes as double taxation to penalize the tourist.

Hospitality industry experts also point out that foreign investors in the tourism sector are shying away from bringing funds because of uncertainty over rules and unjustifiable levels of taxation, such as sales tax, expenditure tax, luxury tax and service tax which vary from state to state. They have suggested that such levies should be made uniform in all states and brought down to the levels prevailing in the rest of the South-East Asian nations. Despite all the constraints of infrastructure and high taxation, tourism is the largest net foreign exchange earner with the smallest import component of 6-7% when compared to other industries. Analysts, highlighting the need to have a renewed thrust in developing tourism in India, say that for every Rs. 10 lakh invested in hotels and restaurants India can create as many as 89 jobs compared to similar investments in agriculture which are able to create only 44.7 jobs or 13 jobs in the manufacturing sector.



To curb the above disincentives the well-known tourism expert, Bernd Chorengel, and President of one of the largest hotel chains, Hyatt International Corporation, has recently suggested a four-point agenda for tax reforms. These are creation of tax incentives for the investor, package of tax sops to attract key global tourism players,

Despite all the constraints of infrastructure and high taxation, tourism is the largest net foreign exchange earner with the smallest import component of 6-7% when compared to other industries

CII recommendations

To boost tourism the government should strive towards achievement of the following targets.

- The plan outlay for tourism has been abysmally low over the years. The share of outlay for tourism must be increased substantially. Once a sizeable amount of money is made available to this sector, only then correct allocation of funds can be made to set up the proper infrastructure necessary for facilitating tourism. Once a proper infrastructure is in place, tourism is bound to flourish.
- For the next five years, Government should have an intensive focus on tourism providing incentives and removing all disincentives in consultation with the industry. Government should actively support capital in the form of domestic and foreign investment and encourage participation of the organized sector.
- In terms of support, government should provide facilities in terms of providing quick clearances (preferably single-window clearances) to potential investors for various projects.
- Land should be made available to projects at reasonable rates.
- In order to make business ventures viable, the government must urgently rationalize the tax structure. There exists a plethora of taxes and sometimes duplication of taxes at both central and state levels. There need to be adequate linkages between the Center and the States on the tax front.

Center and State governments must announce various tax concessions and incentives to enable new tourism projects. In order to enable tax rationalization, tourism may be placed in the concurrent list. The New tourism Policy has already initiated action on this front.

- India being a long-haul destination, civil aviation must play a very crucial role and thus the Civil Aviation Policy (which has been on anvil for quite a few months now) with respect to its bilaterals, airport development, airlines etc., must be in tune with the National Tourism Policy.
- The scrapping of the proposal on visa-on-arrival for security reasons is understandable. However, this practice may be restricted for select nations which pose security threat.
- Tourism's benefits are yet to sink in amongst the masses. Thus, a massive awareness campaign should be initiated to educate how tourism can be a powerful engine for economic growth. In a country which has believed in *Atithi devo-bhava* (Guest is like a God), tourism must involve the communities and local people and it has to be transformed into a 'People's Movement'.
- India's heritage and culture, natural or man-made, should be leveraged as its unique selling proposition (USP). For heritage in the man-made category, government needs to actively promote private participation in terms of adoption of monuments, heritage buildings etc., by providing adequate incentives to the private sector.
- Cleanliness and hygiene at tourist spots figured as one of the major negatives in a survey conducted by CII and A T Kearney on the experience of foreign tourists in India. Thus, it is imperative to maintain cleanliness at least in and around all the major tourist attractions.

Human Resources Development (HRD) is a very crucial aspect for an industry that is largely service-oriented. A focused approach on manpower training is an absolute must. Educational courses at primary level should include tourism. A National Volunteer Corps for Tourism may be modeled in the lines of NCC and some 'learn-and-earn' programs should be started for students and youth during their vacations. A fund should be set up for special training for heritage management.

contd...

Central Government should actively support state governments to build their own 'brand-image' and market that at both domestic and international levels as some states have already started doing.

Of late there has been some degree of sensitization amongst the English dailies on the benefits of tourism and they have started bringing out tourism supplements. The vernacular press needs to be brought into the fold so that the message can be conveyed to the masses.

There is a need for better coordination at three levels:

i. Between Central Government and State governments.

ii. Amongst Central Government ministries and other concerned organizations and departments.

iii. Between Government and industry.

To tide over the current crisis, the government can take some immediate steps to give a fillip to domestic tourism.

- A focused media campaign must be launched projecting India as a 'safe destination'. On the international front special focus should be on the main source markets for India.
- Luxury Tax to be imposed on realized room rate and not on rack rate in all states.
- Government should actively consider keeping Leave Travel Allowance (LTA) outside the tax-net.
- Government should ensure that land availability for tourism projects are made easier and the procedure for obtaining clearances be simplified to attract more investment to this sector.
- For each tourist spot, a Destination Management Authority should be created comprising of empowered local bodies so as to involve local communities to ensure cleanliness and hygiene. Destinations need to be classified in terms of the mix of tourist traffic that they attract, the kind of facilities they should have and the kind of safety and security arrangement that they deserve.
- A happy tourist is the best ambassador of any destination. Proper certified short-duration training modules (of various grades) on courtesy, manners, language etc., should be started for people like guides, money changers, taxi drivers, baggage handlers etc., who form the primary interface with the tourists. The students of Institute of Hotel Management can be used for conducting these training modules. People undergoing these courses should be issued a pass book which would acknowledge the various grades of training modules they have completed.
- Tourist guide is probably the most crucial interface for any tourist. But present licensing policy is completely non-transparent. Tourism industry must be associated with the selection and recruitment of tourist guides and their licensing.
- Tourism should be made a mandatory subject at school levels to foster a better sense of belonging and instill a sense of pride for motherland amongst the future generation.
- Indian politicians, on their foreign trips, should act as Tourism Ambassadors and project India's image as a safe and beautiful destination with loads of attractions to offer.
- Tourists while traveling through various states face unlimited difficulties because of the various taxes that need to be paid to state governments. Taxes on inter-state travel of tourist vehicles should be abolished.
- Abolish Inland Air Travel Tax (IATT) to make domestic flights cheaper.

financial assistance to companies to get into tourism-related investments and introduction of a more rational and simple tax structure for the tourists. The Federation of Indian Chambers of Commerce and Industry (FICCI) has opined that to create synergy there is a need to set up an inter-ministerial forum on the pattern of export promotion councils where the Union and State Government departments concerning tourism, infrastructure and transport should be involved. Decisions taken by such a forum should be binding on every department of the government, the industry chambers observe. It envisaged that efforts have to be initiated to actively involve state governments in tourism promotion. The Government has suggested to the states to produce master plans for tourism development in the respective states. Another strategy that industry experts have suggested is joint marketing that would cover beach resorts to wildlife sanctuaries and temple towns to skiing slopes. This would be a better option than different states pursuing their own strategies. This would help in cost reduction in marketing while offering specifically designed packages for tourists.

There is no doubt that tourism is an important growth industry that can develop into a major forex earner for India. However, to realize its full potential, there is a need for strategic approach to its future development. There is scope for maximizing the growth potential in many markets such as the United States and Europe and emerging markets such as China, Malaysia, Indonesia and the Middle East. While tourism is growing at 4.1% worldwide, competition is intensifying. India cannot assume that it will receive its share as a growing market. Instead, the Indian tourism industry will need to improve its competitiveness in order to increase market share.■

World's Top 15 Tourism Destinations

Rank		International Tourist Arrivals (million)		% Change	Market share
		2000	2001*	2001*/2000	2001*
1	France	75.6	76.5	1.2	11.0
2	Spain	47.9	49.5	3.4	7.1
3	United States	50.9	45.5	–10.7	6.6
4	Italy	41.2	39.1	–5.2	5.6
5	China	31.2	33.2	6.2	4.8
6	United Kingdom	25.2	22.8	–9.4	3.3
7	Russian Federation	21.2	–	–	–
8	Mexico	20.6	19.8	–4.0	2.9
9	Canada	19.7	19.7	0.2	2.8
10	Austria	18.0	18.2	1.1	2.6
11	Germany	19.0	17.9	–5.9	2.6
12	Hungary	15.6	15.3	–1.5	2.2
13	Poland	17.4	15.0	–13.8	2.2
14	Hong Kong (China)	13.1	13.7	5.1	2.0
15	Greece	13.1	–	–	–

Source: World Tourism Organization (WTO) *Data as collected by WTO September 2002

Promoting and Branding

Y CHANDRA SEKHAR

Branding has played an important role in improving the performance of many companies. Similarly, branding also enables the tourism industry to promote its destinations. Tour operators, hotels, state tourism boards are chalking out different strategies including branding to tap the market.

Indian tourism is slowly picking up momentum. While developed countries and developing countries promoted their tourist destinations to reap economic benefits, India has neglected this crucial sector in the past. However, realizing the role this industry plays in the economic development, Indian Government along with numerous other bodies is promoting Indian tourism both at the national and international level.

As a result of recent developments, there is a sharp decrease in outbound travel, thus increasing the demand for domestic destinations. This has resulted in a huge domestic tariff in states like Kerala, Goa, Himachal Pradesh, Maharashtra, West Bengal, Tamil Nadu, Uttaranchal and other Northeast states. With the onset summer holidays tour operators across the nation are flooded with tour package enquires. Industry is optimistic about the actual bookings.

State tourism boards, tour operators, hotels and domestic carriers are adopting different strategies to tap the market. Some of the prominent strategies that they are employing are:

- The airfare factor.
- Creating innovative packages.
- Niche markets: Tapping the most sought after adventure, pilgrimage, and eco-tourism segment.
- Emphasizing on brand.

Going regional

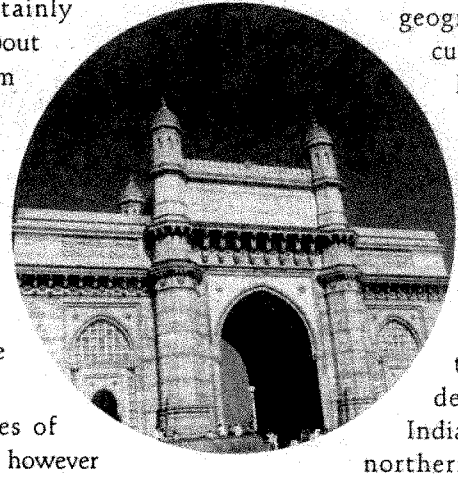
Apart from these measures, some analysts feel that it would be more appropriate to segment the domestic market region-wise and brand wise, i.e., develop a package which will offer destinations in one region like Northern India, Southern India, Eastern India and Western India. Though there is a stiff opposition from certain tour operators to this proposal, some tour operators are packing the programs keeping in view the regional factor.

Big travel giants like Thomas Cook and SOTC are looking at the regional markets to tap the demand and reap the benefits. The regional pockets were once dominated by few travel agents who have served a specific sector of the population. Going by what the travel agents in the past have done, new travel giants are adopting the practice of going communal, designing customized packages for specific segments like, South Indian, North Indian, Hindi-speaking etc., this has become the order of the day.

For example, in 2002, SOTC floated a new package called *Brahman Mandal* aimed at Marathi-speaking population of the country. A similar package aimed at Hindi-speaking population called *Viswa*

Darphan was also floated. According to industry sources, this kind of segmentation will enable the companies to target effectively to boost their revenues. The trigger to float separate packages targeting different sections of the population comes from the belief that there are certain communities, which prefer all travel facilities provided with a regional flavor. In fact, SOTC business improved substantially in Mumbai and Pune circles after the announcement of these separate packages.

Thomas Cook, on the other hand, is aggressively advertising in regional newspapers apart from national dailies. The company has identified that regional marketers are lucrative as disposable income in the hands of middle class Indians in certain regions is increasing tremendously. Hence identifying and promoting products in those regions is a natural business phenomenon. In fact, this appears to be more apt as media has entrenched into the remotest areas of India and this will certainly build awareness about the tourism destinations domestically. Provided a further impetus is given to this awareness, this may lead to an overall development of the industry in India.



These strategies of the big travel giants however are not totally new. They were adopted by the regional tour operators earlier also. Some of the regional tour operators have invested their time and efforts to understand the preferences of their clients and offered packages accordingly. Some tour operators feel that to sell a package to a region or community requires an understanding of finer and deeper feelings, thoughts, and emotions of a community. In fact, understanding on these behavioral patterns provides an opportunity for the tour operators to offer packages that match with the expectations of the end-user in totality.

Tour operators feel that to sell a package to a region or community requires an understanding of finer and deeper feelings, thoughts, and emotions of a community

Branding by region

Undoubtedly, one thing that has been dominated and hampering the growth of the Indian tourism industry is branding by region. The concept of regionalism is hindering the growth over the last couple of years. Exemplifying this trend is the creation of the North-East Brand, 'Eastern Eight' with its slogan 'Eight states, 8,000 reasons to visit'. The traditional approach to promote and market India as a whole—'Destination India', by individual states, has enabled only few states like Goa and Kerala to carve a niche in the global scenario. Perhaps, considering the geographical and cultural diversity of India, promoting it, as a single entity is difficult.

A more practical approach would be to sell the tourism destinations in India by regions like northern, southern, western, eastern and central. For example, the Association of Domestic Tour Operators of India (ADTOI) has decided to develop special North Indian packages aimed at Southern market. Under this package, the states of Punjab,

Harayana, Himachal Pradesh, Jammu & Kashmir and Chandigarh, jointly would promote and project North India as a single destination to domestic as well as international visitors. The special package will include places of pilgrimage, hill stations, adventure sports and other major attractions of these states. While this concept of branding North India is being tested by ADTOI, for this year, plans are there to apply the same to the rest of the regions.

However, one significant issue that can hamper the plans ADTOI is connectivity of these tourism destinations. There is an urgent need to develop rail and air connectivity links between various tourist destinations. Also at the same time, infrastructure development should be addressed.

Though branding of India as a whole represents a challenge to the industry, regional branding may not serve the purpose as desired

A similar approach is contemplated for the Southern India comprising of Karnataka, Andhra Pradesh, Tamil Nadu and Kerala. No one can deny the fact that these states collectively have a rich bouquet of tourism destinations like heritage monuments, wildlife sanctuaries, beaches, hill stations, and a lot more. However, considering the diversity and marketing strategies of the individual states, the idea of branding South may not be feasible immediately. For instance, Kerala is a market leader in the South and may not like to forgo its brand name that it has created for itself. At the same time, other states in the region are getting on to the fast track with large budgetary allocations, providing new impetus to the industry.

While Kerala promotes cultural tourism, Karnataka promotes heritage tourism, Tamil Nadu promotes pilgrim tourism and Andhra Pradesh promotes a mix.

Though branding of India as a whole represents a challenge to the industry, regional branding may not serve the purpose as desired. Since each state has its own strategies for the development of the sector, it may not be possible to unify the strategies and brand either nationally or regionally. A viable option would be to promote India as a whole while promoting the states as sub-brands.■

World's Top 15 Tourism Earners

Rank		International Tourism Receipts (US$ bn)		% Change	Market share
		2000	2001*	2001*/2000	2001*
1	United States	82.0	72.3	-11.9	1.6
2	Spain	31.5	32.9	4.5	7.1
3	France	30.8	30.0	-2.5	6.5
4	Italy	27.5	25.8	-6.2	5.6
5	China	16.2	17.8	9.7	3.8
6	Germany	18.5	17.2	-6.8	3.7
7	United Kingdom	19.5	16.3	-16.7	3.5
8	Canada	10.7	10.8	0.7	2.3
9	Austria	9.9	10.1	1.9	2.2
10	Greece	9.2	–	–	–
11	Turkey	7.6	8.9	17.0	1.9
12	Mexico	8.3	8.4	1.3	1.8
13	Hong Kong (China)	7.9	8.2	4.5	1.8
14	Australia	8.5	7.6	-9.8	1.6
15	Switzerland	7.5	7.6	1.6	1.6

Source: World Tourism Organization (WTO) *Data as collected by WTO September 2002

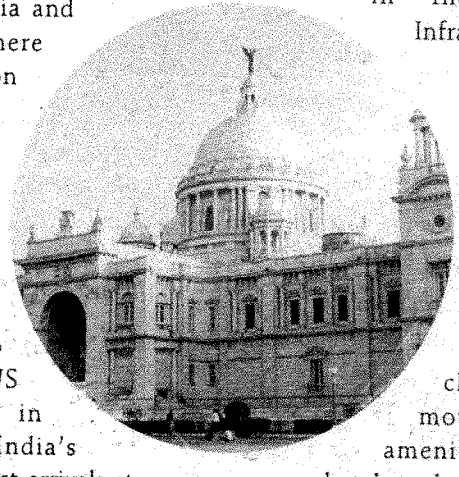
Private Participation
Encouraging Signs

PHANI MADHAV

Regarded as a powerful engine for generating jobs and wealth, this industry provides a host of business opportunities for private players. Encouraging signs of increasing private participation in this sector indicates the potential of this sector.

Worldwide, tourism occupies a special place in the economic development of many countries. It is regarded as a powerful engine for generating jobs and wealth. Tourism is among the world's largest industries and is forecasted to grow 4% annually till 2010. In India the industry has been performing below its potential and has been neglected by the Government for a long time though the potential is huge. According to WTTC research, the travel and tourism economy in India generates employment for 17.7 million people and the potential for creating another 25 million jobs by 2010 exists if Indian travel and tourism generates the same level of employment as the world average. Countries like China, Vietnam, Thailand, Malaysia and Indonesia, where tourism is high on the governments' development agenda, managed to attract a significantly higher proportion of their FDI into tourism and at US dollar levels far in excess of India's achievements. Tourist arrivals at these countries are at three to 10 times that of India. The image of the Indian tourism market as uncompetitive compared to the neighboring countries such as Sri Lanka, Nepal and the Maldives as well as South-East Asia is acting as a major hurdle for foreign investment. The overall image of a high cost and heavily taxed destination with undeveloped infrastructure and poor accessibility is not helping the cause.

But the scenario is changing with tourism industry witnessing heightened attention than ever. More states are realizing the importance of promoting tourism and are encouraging private participation to provide the necessary infrastructure to promote tourism. This in turn translates into never before business opportunity for players interested in investing in India's 'Tourism Infrastructure'.



Opportunities exist in traditional tourism related areas and in new themes. Ranging from setting up of international class star hotels, motels, wary-side amenities, heritage hotels and restaurants to the setting up of golf courses, amusement parks, adventure and water sport complexes, aerial

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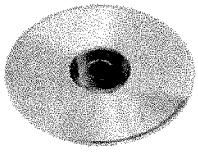

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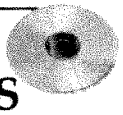

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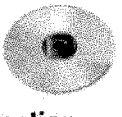

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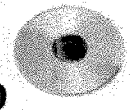

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Tourism Investments and Incentives

Investment policy

- Tourism is a high priority industry and efforts are being made for its rapid development.
- Automatic approval available for foreign equity investment up to 100% in hotel and tourism sector.
- For foreign technology agreements, automatic approval available subject to certain conditions.

Investment incentives

- The Tourism Finance Corporation of India has been set up to help the private sector build hotels and assist in large hotel projects.
- Hotels, travel agents, tour operators, tours and transport operators etc., are eligible for status of Export House/ International Service Export House/Star and Super Star Service Export House.
- The eligibility for granting Service Export House status to the hotel and tourism units is currently Rs. 60 mn.
- Concessional rate of customs duty of 5% for items that are required for initial setting up, or for substantial expansion of the hotel under the EPCG scheme.
- Expenditure tax has been waived in respect of hotels located in hilly areas, rural areas, places of pilgrimage or specified places of tourist importance.
- For financial year 2001-2002, 40% of the profits derived in foreign exchange by hotels, tour operators and travel agents exempt from income tax. Exemption in excess of 40% available if profits reinvested in tourism projects. The above exemptions are being phased out by reducing the quantum of exemptions by 10% each over next four years.
- Move to set up international call centers for reservations and complaints. Call centers are entitled for tax holiday benefits.
- Hotels located in hilly areas, rural places, places of pilgrimage and certain specified locations eligible for a 50% deduction from profit for a period of 10 years, if they start operating between April 1, 1997 and March 31, 2001. Hotels located in locations other than Delhi, Kolkata, Mumbai and Chennai are eligible for a 30% deduction from profit, for a 10-year period.

Other incentives

- Attractive interest subsidy for hotel projects in the one to three-star category.
- Incentives for conversion of any heritage building (palace, bungalow etc.) into a heritage hotel.

Source: Ministry of External Affairs

Apart from improving the hotel accommodation capacity, there is a great need for development of other tourism related services like travel and tour operators

ropeways, cruises, domestic airports and more. Tourism industry in India has the capacity to absorb additional investment of US$ 10 bn. According to estimates, India will need 130,000 hotel rooms to accommodate the expected inflow of 5 million tourists over the next few years. Apart from improving the hotel accommodation capacity, there is a great need for development of other tourism related services like travel and tour operators and others that can provide leisure, entertainment and convention facilities. India is the fifth largest economy according to the Purchasing Power Parity (PPP) criterion. The growing middle class, the huge growth in the outbound market, the opportunities to invest

in infrastructure makes it an attractive proposition for investors. Many states are introducing the Single Window System for clearing the investment proposals.

The Department of Tourism acts as a nodal agency for promotion and development of tourism and allied industries. The Central Government provides financial assistance for developing infrastructure on a cost-sharing basis to the State Governments. The State Governments meet the cost of land and its development while the Central Government meets the cost of construction. The Department of Tourism, based on recommendations received from the State Governments, identifies projects that have the potential to accelerate tourism growth in India, for implementation. Various corporations and institutions such as the Indian Tourism and Development Corporation, Indian Institute of Tourism and Travel Management, National Council for Hotel Management and Catering Technology, National Institute of Water Sports etc., play a crucial role in development of tourism and allied activities by assisting the Department of Tourism.

To make it easier for investors to set up new projects including identifying locations and the type of investments required the Department of Tourism of the Government of India in consultation with the various State Governments has worked out a plan of potential projects. The Department of Tourism is also initiating various measures to help investors in getting project clearances and permits for the industry. Recently the Government withdrew expenditure tax, incentives for financial institutions that advance long-term capital to hotels in three-star and higher categories and announced the continuance of exemption of service tax.

According to the World Tourism Organization, some of the steps taken by the Government to accelerate tourism growth are:

- Reduction in entry fee and passenger tax for monuments.
- Over 17,000 additional international air seat capacity.
- Maximizing use of information technology for promotion.
- Touch Screen Information Kiosks.

Encouraged by the Government's interest, international companies have made a foray into the tourism industry through joint venture and franchise, thus fueling a tremendous pace of expansion and development in the accommodation and tourism-service sector. After a two-year slump, the industry believes that tourism will bounce back in 2003. In 2002, while domestic tourism has grown by 30%, international tourist arrivals increased by 16% since November 2002. Even those hotel projects, which were shelved, are seeing an inflow of investment.

In the newborn states of Uttaranchal and Chattisgarh there are many potential spots for hospitality investment. These states are looking at tourism as a major source of revenue and are putting in efforts to create an investor-friendly environment. Uttaranchal is inviting 100% private investment in tourism projects and has entered into a memorandum of understanding with the Infrastructure Development Finance Company (IDFC) to lease out tourism properties in the state.

International companies have made a foray into the tourism industry through joint venture and franchise, thus fueling a tremendous pace of expansion and development in the accommodation and tourism-service sector

Foreign Tourist Arrivals in India During 2002 and Corresponding Figures for 2000 and 2001

Month	Foreign Tourist Arrivals			Percentage Change	
	2000	2001	2002	2001/00	2002/01
January	2,53,666	2,83,750	2,28,150	11.9	-19.6
February	2,57,403	2,62,306	2,41,133	1.9	-8.1
March	2,34,606	2,48,965	2,16,839	6.1	-12.9
April	1,88,132	1,85,338	1,55,378*	-1.5	-16.2
May	1,39,575	1,51,098	1,32,988*	8.3	-12.0
June	1,61,613	1,76,716	1,43,100*	9.3	-19.0
July	2,12,949	2,24,432	1,86,482*	5.4	-16.9
August	1,86,843	1,96,517	1,61,477*	5.2	-17.8
September	1,80,070	1,62,326	1,51,721*	-9.9	-6.5
October	2,30,978	1,81,605	2,12,191*	-21.4	16.8
November	2,90,201	2,09,685	2,43,566*	-27.7	16.2
December	3,13,342	2,54,544	2,81,102*	-18.8	10.4
Total	26,49,378	25,37,282	23,54,127*	-4.2	-7.2

Foreign Exchange Earnings During 2002 and Corresponding Figures for 2000 and 2001

Year	In Rs. cr	% Change	In US$ mn	% Change
2000 (Jan.-Dec.)	14,238.00	–	3,168.00	–
2001 (Jan.-Dec.)	14,344.00	0.7	3,042.00	-4.0
2002 (Jan.-Dec.)	13,643.81*	-4.9	2,811.14*	-7.6

*Provisional

Source: Federation of Hotels and Restaurant Associations of India

The state is also promising up to 20% assistance for projects ranging from fast food joints, handicraft outlets and amusement parks to transportation and accommodation facilities requiring investment up to Rs. 10 lakh.

In south, Andhra Pradesh is one place where there is a lot of action taking place and is being considered as a happening place. With Lufthansa starting its operation, the state is well connected to places in the Middle East, South-East and Europe. The state is also marketing itself well. On accommodation front, the growth of hotels has helped the state to be prepared for the increased tourist traffic.

Though the commitment from Government is showing some results, the scope is much more than what is being witnessed today. By recognizing the vast potential of tourism in achieving socio-economic objectives, Government should play a more proactive role and assess the reasons for this poor performance and address them to enable tourism to make an appropriate contribution to national development.■

Tour Operators

Increasing Participation

ANAGGH DESAI
CEO and Executive Director
Traveljini.com Ltd.

Tourism industry is experiencing substantial growth in terms of domestic travel. To sustain and build the momentum, tour operators have to play a proactive role. This will ensure the overall development of this industry.

The tourism industry is very susceptible to global events and happenings. The last couple of years have been the worst years for the industry. After the 9/11 incident most of the top airlines reported losses and some of them filed for bankruptcy (Swiss Air, Sabena, Qantas, American Airline etc.), the hotel industry was also not spared by the event as most of the hotels showed a 30% dip in the occupancy rate during the event. The war in Afghanistan and in Iraq added to the slump in travel industry. Now, SARS has affected this declining industry; most of the middle class Indians who could afford a holiday in the South-East Asian countries have canceled their plans for this year.

Having said this, the fact remains, that the industry is undergoing both a consolidation as well as innovative phase in terms of sales and product development.

There has been a substantial growth in terms of domestic travel, both in terms of exploring new locales within the country as well as pattern of travel (changing from Train to Air) due to the prevalent offers.

Concerns

The priority issue is about creating a global image / brand called 'Travel to India' or on similar lines in the high income markets. Support has been given by the Government of India for infrastructure, boutique hotels in terms of tax benefits etc. So that they can compete with the bigger players and offer similar services to their clients at better rates. And above all to treat tourism in India as a preferred industry which brings in substantial revenues and is capable of doing much more.

Outlook

Internet is becoming a very powerful medium of information for booking of hotels and airline tickets. Close to 80% of people worldwide source travel information via the Internet regarding airline, hotel or travel websites, out of which 15% really book via the Net. This rapid growth happened in less than five years. In India most of the airlines as well as hotels have realized the potential of this medium and are propagating the usage. Technology and automation is also a great contributor to this growth and in the coming two to three years should see a major thrust in the medium.

The past two years have taught the industry in India not to take anything for granted, which has also helped the industry as a whole to evolve into a more proactive, innovative and focused one, which should bear results in the coming couple of years.

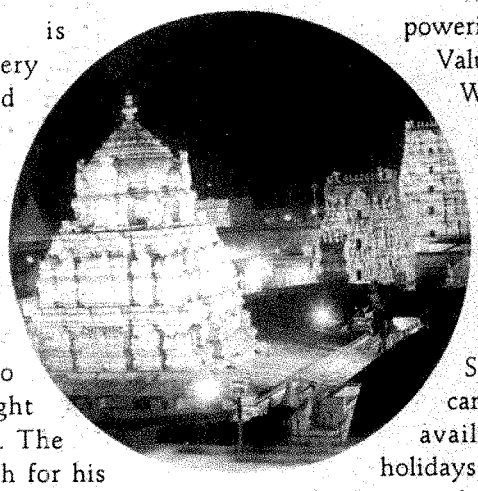
Initiatives of Traveljini

- Traveljini is a travel portal that caters to the needs of the traveler. It presents the user a variety of offers on travel holidays, hotel bookings and airline tickets (international as well as

domestic) along with other travel services like forex, travel insurance, information of hotel properties etc. Since it is online the user can log onto the site anytime of the day and make a booking or surf for travel information.

- An IATA recognition gives the leverage to get the best of fares and deals from all the airlines' operations from India (domestic as well as international airlines).
- Traveljini has access to the best of travel suppliers around the world and India to create and promote holiday packages at VFM rates.

  It has a user base of close to 1,10,000 who actively use its services. Traveljini firmly believes in alliances and relationships and use of technology and automation to add value to these alliances, which form a closed user group. Its current alliances include, banks, cellphone and telephone companies to name a few.



  Traveljini is technically very advanced and supports online real time bookings for hotel rooms in close to over 600 hotels.
- Traveljini also has online flight search engine. The user can search for his preferred airline on his preferred date of departure and check his availability. It will soon be moving to an advanced flight-booking module where a user can directly book his flight tickets on any airline in the world.
- A user can book his holiday online on Traveljini by paying through his credit card or via other bank accounts like IDBI, GTB, Centurion Bank, ICICI. Traveljini also accepts cash, cheques and accepts demand draft facilities.

It has alliances with the best of brands of Corporate India. Some of them are as under:

Mobile brands

Mobile brands provide travel content and holiday deals to the following mobile brands: Orange and Hutch, IDEA Cellular, Reliance, Escotel, Spice.

Banks

- Have online payment gateways associations with the best of banks: IDBI, ICICI, GTB, Centurion Bank—They power intranets for travel holidays for HSBC and ICICI.
- Power Internet for travel holiday for the following banks: IDBI Web shop and ICICI Internet.
- Will soon be powering HDFC's My Value Shop website. With StanChart bank the service will soon be promoting 'Insta buy' for travel holidays.

  Here a user having a StanChart credit card will be able to avail of travel holidays on EMI with a 0% interest scheme on the same.

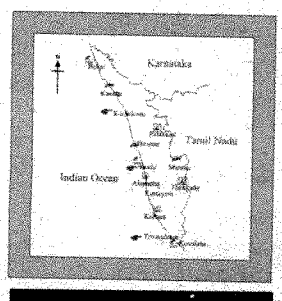
Other online brands include: Relationships for promotion of travel holidays with rediff.com, indiatimes.com, baazee.com, mantraonline.com, roltanet.com, and hclinfinity.com.■

Kerala

The Emerging Role Model

Y CHANDRA SEKHAR

Exotic beaches, backwaters, rich culture etc., are some of the rich attributes of Kerala. Backed by these natural gifts, the state is dominating the tourism industry with new and innovative products.



One state that has shown remarkable performance in the growth of tourism sector in India is undoubtedly Kerala. Being a small southern state, it is dominating the tourism landscape. Blessed with beautiful beaches, backwaters and a rich culture, this state is drawing the attention of visitors, not only from India but also from abroad. Tourism has its roots deeply penetrated into Kerala's economy and growth that it has become one of the major industries that drives the state today. Right from employment to revenue generation, tourism has entrenched the lives of almost all Keralites.

Innovative means

Keeping pace with the changing preferences of tourists, Kerala tourism has been very innovative in promoting its destinations to the visitors. Internationally renowned tourist destinations are not able to provide any new experience to visitors and are facing stagnation in growth. However, Kerala is providing a new experience to its visitors every time. The secret behind this is simple. First, it was the backwaters (commonly referred as backwater tourism) that promoted tourism activity in the state. Then it was the turn of Ayurveda, which induced many visitors into the state.

After backwater tourism and Ayurveda, it is now Cultural Tourism—a unique product developed for the first time in India. In this new venture, Kerala tourism in association with Kerala Kalamandalam, an educational institution, which promotes classical arts, will promote the classical heritage of the state. In fact, Kerala Kalamandalam is the only place where ancient system of learning—Gurukula exists in its true sense. Under the joint venture, a program 'A day with the Masters', was formally inaugurated on February 14, 2003. The program is a journey into the heart of Kerala.

George Dominic, Executive Director, Casino Group of Hotels after attending the program has stated in a press meet that it is a trip through the corridors of Kerala where life is an art, time is tradition and where the past, present and future co-exist. This apt description of the program will definitely induce many high-end visitors to the state.

Not only launching of new products, Kerala tourism is also networking with other states to lure high-end visitors along with other prominent places of visit in India. Recently, Kerala tourism has signed a MOU with Rajasthan tourism department as the partner state for joint promotion of tourism at the national level. This is the first time that the two states have entered into an agreement over the promotion of tourism. The Kerala State Government has urged the Union

"Kerala Tourism has been a front runner among the Indian states in terms of its marketing efforts, new product development, creation and maintenance of quality standards etc., across the last 10 to 12 years"

– Alkesh Kumar Sharma,
Director, Kerala Tourism Development Corporation Ltd.

I think this will be the first time ever that almost all the states in the country are aggressively promoting tourism alongside the India Tourism—right from the traditional strongholds like Rajasthan and Goa; Kerala the catalyst and newborn states—Uttaranchal and Chattisgarh.

This is happening when the West is looking at East for holiday options and the East's outbound market is growing exponentially. The main reason for this is the stagnation faced by the traditional Western destinations and the growth of the Eastern destination, mainly the Asia Pacific. I strongly believe that India should capitalize on the opportunity by positioning itself rightly in the minds of the target audience and attract them to visit the country, which probably offers the most varied mix of holiday options and experiences in the world.

Kerala Tourism has been a front runner among the Indian states in terms of its marketing efforts, new product development, creation and maintenance of quality standards etc., across the last 10 to 12 years. The state was the first to put forward a vision plan named—'Vision 2025', which envisages every aspect of the tourism industry of the state and works as a guideline for all kinds of tourism activities for the next 25 years.

Today, tourism has transformed itself into the most suited industry for the state and God's Own Country has achieved an iconic status among Indians and has become recognizable among the key foreign markets. In achieving this the industry has given the state a lot of backing in terms of revenue, employment opportunities and better infrastructure to mention a few.

As the travel and tourism industry is going through another catastrophe in the form of the Iraq war, Kerala Tourism is preparing hard for the next season and is taking steps, which we believe would bring in more tourists than last year. Continued trade contacts, active participation in trade fairs etc., are some of the war time measures we have pursued.

Civil Aviation Ministry to introduce Jaipur-Thiruvananthapuram flight via Goa to enable the high-end tourists to see the best of India. Under the agreement, it has been proposed to extend the Rajasthan's prestigious Palace on Wheels train during off-season to Kerala, subjected to clearance from the Railway Ministry. Both the states felt the need to compliment each other through individual tourism assets and evolve as role models for the growth of tourism in India.

Kerala and Rajasthan felt the need to compliment each other through individual tourism assets and evolve as role models for the growth of tourism in India

According to the proposals of the agreement, both states will collaborate for joint marketing and publicity of tourism. This also includes a joint participation in international events and road shows. With regard to the various packages offered by the respective states, a joint packaging of complimentary tourism products will be formulated thus providing the best of India to the tourists. Also the states will strive for agreements with air carriers for direct connectivity along with designing of innovative products, which will include rail-based projects covering the states.

Undoubtedly, the emphasis and the lead taken up by the state in promoting tourism will make it a role model for other states.■

Budget 2003-04

A Growth Booster?

PVL RAJU

The budgetary support extended by the Government has given an impetus to the industry. Coupled with the restoration of LTC and 10-year tax holiday for industrial activities, the budget is hailed as a catalyst for tourism industry.

The budget 2003-04 has approved an allocation of Rs. 100 cr for tourism. Coupled with this the restoration of LTC has given the shot in the arm for the industry. Apparently, things look encouraging for the tourism sector and the budget claims tourism as "amongst the most effective employment creating sectors". The government has granted a 10-year tax holiday for industrial activities in states like Uttaranchal, Sikkim, Himachal Pradesh and the Northeast states, which recognize tourism as a thrust area. The states have hailed the budget as a catalyst for tourism industry.

LTC to government employees implies a boost to domestic tourism. "The India-to-India business has grown immensely in the last one year. LTC will enhance the growth further reaping good business for hotels and domestic tour operators," commented an industry expert. In fact, many tourism associations have been strongly lobbying for it.

There are however few gaps here and there. Much will depend on whether the airport reception structure is made tourist-friendly and movement to the final destination faster and hassle free. It is equally important that tourist hubs will only work if sets of strong national carriers are created simultaneously. At present the fragmented domestic and international carriers and there are not enough aircrafts to make the hub and spoke system function efficiently. Though Air-India and Indian Airlines have common ownership, they have disjointed style of functioning. The first step should be to merge Air-India and Indian Airlines so that they can complement each other and have a large fleet.

The increased focus and good funding to road projects will bring in four-lane roads apart from developing national highways. This will really augur well. A survey carried out through Rainbow Travels shows that foreign travelers visiting India prefer fewer flights as security checks are intolerable and there's a huge loss of time in airports. "When good roads and expressways come up, tour operators are going to increasingly move away from air travel," says the report.

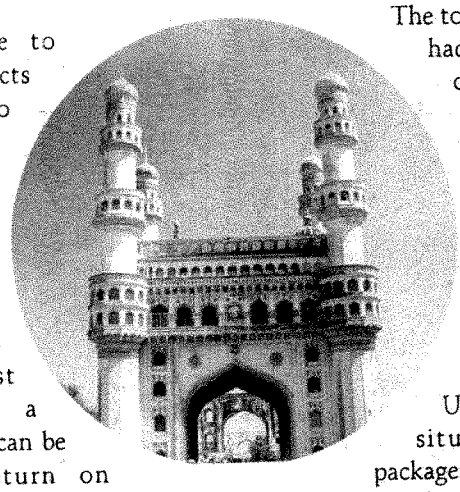
The expectations of aviation industry have fallen short in the budget proposals. The only cosmetic touch is to give a comprehensive face lift to Delhi and Mumbai airports at an estimated cost of Rs. 11,000 cr. Industry experts feel that tourism and aviation should essentially be granted infrastructure status.

That the hotel associations apparently are the luckiest of the lot as the FM has generously doled into their kitty. Hotel Expenditure Tax has been abolished, hotel companies have been permitted to set off past losses in case of mergers and de-mergers, hotel projects will get finance at lower interest rates like other infrastructure projects, basic duty on imported liquor and wine

has been reduced from 182 to 166 % and service tax exemption will continue—a wide array of concessions literally on a platter. The bourses have instantly responded—stocks of eight actively-traded hotels saw a 6% spurt in their market capitalization. Experts feel that for the first time any finance minister has recognized the true potential of the tourism industry, which can create more employment than the manufacturing industry.

Of course the fine print will, however is a dampener of sorts. Waiving HET means total hotel billing of customers will now become 10 % cheaper. However, how many tourists had been patronizing hotels that charge HET is an important question. Almost 75% of travelers do not access hotels that come under the purview of HET. Hence, the benefit will accrue to a select few and not all tourists. In essence this relief will impact limited hotels and limited customers.

The incentive to finance hotel projects is designed to encourage investment as projects would now be cheaper by 30-40 %. But the point is that hotel companies will only invest when there is a demand and they can be sure of the return on investment. Unless the traffic to the country picks-up the ROI will not be favorable and no big investments can be expected to take place. If the market bounces back, the incentive under 10(23G) will definitely act as a catalyst in hotel growth.



For the first time any finance minister has recognized the true potential of the tourism industry, which can create more employment than the manufacturing industry

The FM has deftly paid with both his hands. His right hand has funded his left hand, in a manner of speaking! He decided not only to widen the ambit of service tax, but enhanced the rate as well from the existing 5 to 8%. Under the new system, however, the tax will be eligible for input credit. Thus, businesses can now pass on the tax to the end consumer. In other words this implies—travel agents would now have to either cough up more tax, or charge clients. A typical Catch 22 situation. The hard times have seen them doing business on thin margins—sometimes even sharing a slice of their Productivity Linked Bonus with clients. While passing on the tax to consumer would mean a hike in the cost of service, absorbing it would leave them a shade poorer. Not a very comfortable situation to be in, for the one sitting on the other side of the business desk.

Situation is quite dicey for the tour operators. Earnings from foreign exchange will now not be exempted from service tax. The tour operators so far had to pay tax only on the rupee billing—5% service tax on ground services and 2% on overall packages which include hotels, air tickets and ground support. Under the current situation, a dollar package will also attract 8 % tax, which in black and white means the tourists hardly gain anything from exemption of HET as most of the tourists are budget hotel clients. In fine, the budget appears to be an exercise in sound and fury signifying nothing!■

Tourism
Some Areas of Concern

CSV RATNA

Though India is known for its tourist destinations, the industry has not picked up as anticipated. For the industry to flourish, the factors that are hampering its growth have to be addressed and resolved at the earliest.

Do you know that tourism is the fastest growing industry in the world? Yes, annually it generates more than 230 million jobs and contributes billions of dollars, collectively, to the economies of countries across the globe. In most developing countries, it is the principal means of job and revenue generation.

India, the prominent name among the developing lot, is renowned worldwide for its tourist places. The heritage and diversity of India lures many people annually towards its cities and towns. However, tourism industry is in its infancy in the country, accounting for a meager 6% of the country's GDP. It accounts for just 2% of tourist arrivals in Asia Pacific and less than 0.5% of world tourism traffic. Also, India's share in international tourist arrivals has been a measly 0.37% while the share in world tourism receipts has been 0.66%. The country is ranked 46th in the world for tourist arrivals.

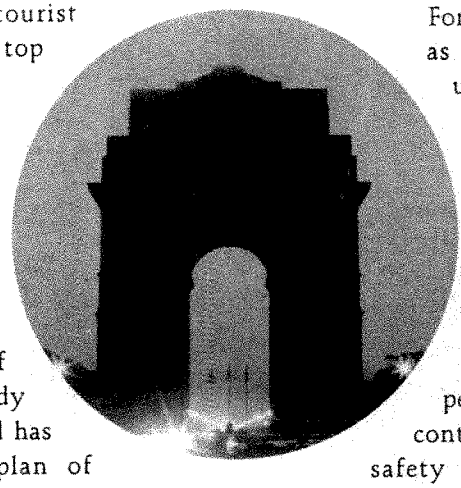
For India to grow and mature, it needs ample support from the Government, both State and Central and active participation of the private sector. With the collaboration of the public and private sectors, procedural, infrastructure, implementation and operational glitches can be eliminated, and the tourism industry can flourish.

Causes of concern

All these years, there was very little and highly unplanned activity going on for the development of tourism. Even though tourism was considered an important sector, the plan outlay for tourism has been appallingly low over the years. The budget for the industry has been only 0.11% of the total plan outlay. Over the years its share in the total outlay has come down. It was 0.19% for the financial year 1992 and is 0.13% in 2001. While the Government of China's expenditure on tourism is 3.8%, that of Sri Lanka's 4%, US' 3.9% and Singapore's 9.1%, India's is only 0.9%. Worse still, the bottlenecks in the clearances to potential investors for various projects are severely hampering the growth of the industry. Also, the tax regime, with its glut of taxes and sometimes duplication of taxes at both Central and State levels, is proving to be a major hindrance.

Briefly, the major concern areas for the industry are the high level of taxation at both Center and States, lack of coordination between State and Central Governments, absence of professional marketing, improper infrastructure facilities, unhygienic conditions in some tourist destinations and procedural glitches arising out of old and redundant ways of doing business (for instance, no use of IT).

These days, the Indian tourism industry is increasingly seen as promising for many national and international organizations. It presents a business opportunity of a lifetime for the companies investing in it, especially if the investments are in tourism infrastructure. Currently, India has 300 million domestic and foreign tourists and the numbers are bound to grow in the future if proper planning is done. To give a thrust to the tourism industry, seven S's denoting the focus areas have been identified, which are: *Swagat* (the welcoming part), *Soochana* (providing information), *Suvidha* (providing facilities), *Suraksha* (ensuring safety), *Sahyog* (building cooperation), *Samrachana* (developing infrastructure) and *Safai* (ensuring cleanliness). In fact, in a survey conducted by CII and A T Kearney on the experience of foreign tourists in India, cleanliness and hygiene at tourist spots was one of the major negatives. Thus the drive to ensure *safai*, in and around tourist destinations, is a top priority.



Encouragingly, tourism figures at the top in the Prime Minister's priority list. The Department of Tourism of the Government of India is already working on it and has chalked out a plan of potential projects in consultation with the various State Governments. The plan envisages developing transport, hotels and other infrastructure to increase the inflow of tourists. Both the State and Central Governments are actively working towards improving the industry; however a few hindrances have to be weeded off if the industry hopes to retain its luster.

India has 300 million domestic and foreign tourists and the numbers are bound to grow in the future if proper planning is done

Policy changes: Brightening prospects

The new tourism policy envisages a Government-led framework, which would be driven by the private sector and work toward community welfare. It also emphasizes issues such as the carrying capacity of tourist site, thrust to rural tourism and tourism in small settlements so as to promote local art and craft. Special consideration would be given to pilgrimage destinations and prominent attractions like Yoga, herbal massages, spiritual healing, traditional cuisine etc., would be encouraged.

The policy even persuades the travel industry to voluntarily adopt a Code of Ethics. Any breaches on this matter would invite firm disciplinary action by the Tour and Travel Associations.

Foreigners see India as one of the most unsafe tourist destinations. Incidents of duping, exploitation and harassment of tourists have only fueled such a perception. In this context the issue of safety and security of tourists assumes paramount importance. The new tourism policy aims at ensuring safety and security of the tourists. It suggests that states allocate a section of the state police force to operate as tourist police. Special training would be given to

the police for their new role. Already, Goa, Kerala, Jammu & Kashmir, Rajasthan, Himachal Pradesh, Maharashtra and Andhra Pradesh have grouped Tourist Police for providing safety and security to the tourists.

One of the most important proposals of the New Tourism Policy is that of placing tourism in the concurrent list. But eight states have opposed this move and three others are still in doubt, while the rest of the states and union territories agree with the proposal. Even then all the efforts are under way to get an unanimous agreement on the proposal.

While the tourism policy hopes to set many anomalies right, the Union Budget for the current financial year has also given a fresh impetus to the industry. The budget identified the tourism sector as a priority sector and increased the plan outlay for it by 50%. The budget also proposed to develop six circuits into tourism hubs of international standards along with developing the World Heritage Site of Hampi as an international destination. Special Purpose Vehicles (SPVs) are permitted to raise resources from public as well as private sectors for infrastructure development in those six circuits.

The Government even decided to rev up the air transport infrastructure by upgrading the international airports of Delhi, Mumbai, Chennai and Kolkata to world class, by way of inviting private sector management. As parent of this revamping effort, Inland Air Travel Tax (IATT) on air travel from and to North East has been exempted. As regards the hospitality, service tax, in cases of functions and banquets where the entire bill is for catering services, is exempted and customs duty on imported liquor reduced from 210% to 182%.

Assuring and ensuring

These moves by the Government are only small signs looking up; there is a lot that needs to be done for the industry to reach its full potential. Even though India has one of the richest cultural heritage and the widest range of geographical diversity, it has been lagging way behind other countries, especially China. In 1978, both China and India attracted equal number of foreign tourists but today more than 27 million international tourists visit China while India gets about one-twelfth of that number as tourists.

On top of it, events like September 11, the recent Iraq war and the SARS scare have affected the Indian tourism industry. In fact, estimates put India's tourism industry's loss since the terror attack in the US at around $200 mn. While these events, especially SARS have affected China also, the chances of the lasting period of the effect may not be as much as India's. It is increasingly felt among industry experts that the Indian tourism sector is marred by passivity of the Government. And even though the Government has lately become quite active, the sector needs a big fillip.

India's tourist traffic is mostly from US and Europe. Even when India registered a decline of 4.2% in international arrivals in 2001, UK and USA remained the top generators of inbound traffic. In that year, of the 2.54 million international arrivals, 0.48 million were from neighboring Pakistan and Bangladesh. Other countries like Sri Lanka, France, Canada, Japan, Germany, Malaysia, Australia and

While the tourism policy hopes to set many anomalies right, the Union Budget for the current financial year has also given a fresh impetus to the industry

Singapore were figured in the top 10 inbound traffic generator list. Tourism receipts in 2001 were to the tune of US $3.04 bn and here also tourists from US remained the highest spenders. In fact, according to industry experts India gets about 2.5 million visitors every year, 30% of that figure being tourists and 90% of these tourists are from US and Europe.

Closer home, neighboring countries like those in South Asia accounted for about a quarter of India's inbound tourist traffic.

Keeping this in view, visa procedures and other procedural hassles have to be eased out. The recent scrapping of the proposal on visa-on-arrival for security reasons is a step to ensure security but such moves have to be limited to countries which are likely to pose a threat rather than to all countries. Foreign tourists need to be assured of the safety and security. At the same time they have to be educated on the culture and heritage of the country. In this regard, the private sector has to be encouraged to maintain the heritage.

Industry studies reveal that youth constitute a bulk of the inbound traffic. There is a growing interest on India among the world's youth. Consequently, tourist events aimed at the youth have mushroomed. Popular among the many events targeted at these tourists is adventure tourism, constituting river rafting, mountaineering etc. The adventure tourism sector is estimated to be growing at a rate of 20% per annum in the country.

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Domestic tourism: Need for push

Just as international tourism, domestic tourism also needs to be encouraged. India has been lagging far behind other countries in its efforts to boost domestic tourism. Consequently it has been noticed that Indians are holidaying abroad rather than within the countries, thereby creating a dent in the foreign exchange reserves. With the upwardly mobile population increasing and with the shift to westernization, Indians are increasingly visiting foreign locales, at the expense of the domestic tourism sector. Some reasons for this skew is the exorbitant costs of domestic travel and its price-incompetitiveness in relation to neighboring tourist destinations as a result of high taxes on tourism. In 2001, the outbound tourists were around 4.07 million.

Because of the concerns of war and increasing fear of terrorists coupled with fright of diseases like SARS, the international tourist traffic is sure to reduce. Thus domestic travel, which was adversely impacted by militancy in Jammu and Kashmir, terrorism in Punjab and North Eastern states, and naxalism in Andhra Pradesh, becomes the prime and steady source of income for many states. Many states, which are complacent because of the huge inflows of foreign tourists have to realize the importance of domestic tourists and may have to redraw some strategies to attract them.

The tourism industry in India is evolving fast and will soon mature into a big industry offering numerous opportunities, once some irregularities are set right. Though Government is going in the right direction by making some important policy changes and by increasing the outlay, for all that to happen, the implementation has to be right. And, here the Government's role is more important.■

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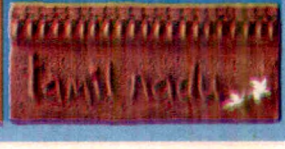

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UNITED AIRLINES

In troubled skies

Like most other airlines in US, United Airlines is also taking a bumpy flight through troubled skies. What has compelled this organization, which was the industry leader of the yesteryears, to become impecunious all of a sudden? What lessons can other airlines learn from the UAL's experience and what are the possible remedies to bring it back on track?

Aggressive competition, dynamic customer needs, unfriendly cost structures, downsizing of staff, shift in the business models; this is how one can appropriately describe the US airline industry scenario of late. Added to these, the roller-coaster of boom and bust in the economy has aggravated the woes of the industry significantly. These precarious conditions led to the downturn of many established airline giants. One such organization is United Airlines (UAL). With the abysmal figures projected in the 2002 financial statements of the UAL, the performance of the organization leaves a lot to be desired. It would be hasty if any single factor like ESOPs or the inefficient management were held solely responsible for the downtrend. UAL's turmoil is a result of a number of things, a multitude effect. On asking as to what are the various factors responsible for the mishap, Andy Voung, *Denver Post* Business Reporter says, "First, their labor costs were higher than any other airline in the industry. Second, external factors, from the stock market crash to the rise in online bookings to the September 11 terrorist attacks, all played a role in compounding UAL's problems. Third, management made poor decisions, such as launching Shuttle by UAL, the company's failed attempt to create a discount airline within an airline, the ESOP gave employees too much control of the company. Simply put, UAL's costs far exceeded its revenues. Revenues have declined significantly since 2000, yet costs continue to rise."

A brief EIC analysis

The US economy is passing through turbulent times. Due to the untoward incidents like September 11 and Gulf War II, a quick recovery remains less certain. These economic busts have had a severe impact on the airline industry. Traffic beginning to rebound and some airlines are adding flights. However, as of now, it seems that traffic in 2003 will increase very slowly and will not reach levels that the industry had achieved in 2000. The airline industry is a major contributor to US economy. In 2000, the total impact of civil aviation on US' economy was approximately 9% of GDP and involved some 11 million jobs. Commercial aviation (the airlines) accounted for the vast majority of that economic activity—roughly $800 bn worth—through direct, indirect and induced spending. The fact is that America depends on aviation. Government has a crucial role to play ahead by way of assuming the full cost and responsibility for assuring the protection of aviation against terrorist attacks, and do everything possible to encourage and uplift the airline industry.

After a $7.7 bn loss in 2001, the airline industry continues to struggle in the post-September 11 changed environment. Analysts say that losses will exceed $9 bn in 2002, for a two-year total nearing $17 bn. The untoward incident of 9/11 has also led to the plummeting demand in the airline industry. As a measure to encourage the return of passengers and raise the demand levels, airlines have been forced to offer dramatically lower prices. At the same time, higher federal taxes and fees compound the pressure on prices leading to meager revenues to the industry. Passenger revenues for January through September 2002 are 16.4% below the same period in 2000 that resulted in a cascading effect including, cost controls, massive retrenchment of employees etc.

United they fell

It was a disappointing and disheartening financial year for the US airline giant UAL. The happenings at UAL were in unison with the economy and the industry, witnessing massive layoffs, cost reductions etc. The workforce that was more than 1,00,000 in 2001 shrunk to about 70,000 today. The airline giant that in the past was in a position to claim several firsts to its credit is now on the brink of bankruptcy. UAL that stood number one in on-time performance for all of 2002 reported a loss of $1.3 bn for the first quarter of 2003. This loss is being said to be the carrier's second-worst quarterly result ever and the biggest by any airline for the period. With all these adverse developments, UAL had no option but to refer to the Chapter 11 of the United States Bankruptcy Code under which UAL, United and 26 other direct and indirect wholly-owned subsidiaries voluntarily filed petitions for relief.

There is no denying to the fact that the economic and sector-specific factors were responsible to a significant extent, but at the same time company-specific factors that were responsible for the southward

ourney of UAL cannot be exempted. Some of the factors that are UAL-specific include poor customer care, ESOPs, business model etc.

Customer care: UAL's track record has not been impressive when it comes to the passenger care. It is an obvious desire of a flight passenger that he is given a comfortable and friendly treatment on the board. UAL, on the contrary, failed to achieve this criterion. Flight delays and less quality dinners have been UAL's regular features. For instance, a specially ordered Hindu vegetarian meal was covered with onions and garlic, with a fish sauce—despite the fact that the customer had rung them to confirm his meal five days before! This shows the sheer negligence and care-a-damn attitude towards the customers. Broken seats and unkempt lounge and arrogant crew had become the visible characteristics of UAL.

ESOPs: Though the entire blame cannot be dumped on the ESOP's policy of UAL, it played a prominent role in its fall. Eight years ago, workers at UAL had agreed to give up $700 mn in wage cuts and work-rule concessions. That, in turn, facilitated them with the chance to buyout many of the airline's executives and public shareholders and to form an employee stock ownership plan, or ESOP. From 1994, during the period of six years of the ESOP era in UAL, United workers accumulated 55% of the stock in parent company UAL in exchange for pay and benefit cuts. The strategy behind the move was giving up the short-term benefits in favor of the long-term gains. But the dream remained far from materializing as a result of few developments like the non-participation of flight attendants, workers' inability to sell their stock until they quit or retired, a freeze in 2000 that excluded employees hired after that date from the ESOP, and a new governance structure that gave employees no direct vote on directors. As a result, the share price of the UAL that, on announcement of ESOP, skyrocketed from $30 per share to $100 nosedived to meager $3. Here it would be unjust to blame ESOP alone. What were actually responsible is the inability and the inefficiency of the management to manage the plan. Studies indicate that companies with ESOPs can grow 8 to 11% a year faster than they otherwise would be expected to grow. But such a successful disposal of the plan demands a participative and an efficient management. When asked to opine on the role of ESOPs in the UAL story Corey Rosen, Executive Director, NCEO (National Center for Employee Ownership) says, "I don't think employee ownership led to UAL's problems—after all, institutional ownership did not lead to the same kinds of problems at every other airline except Southwest and JetBlue (both of which have employee ownership). The problems had more to do with a cost and route structure that just didn't work in the current environment. UAL certainly has lessons to learn from its peers in the industry like Southwest Airlines which is 12% owned by an employee profit-sharing plan and is being managed successfully."

Hub and Spoke model resulted in airport congestion, slow aircraft turnaround on the ground, and inefficient use of equipment and people

Perhaps because of the indifference toward making the ESOP part of UAL's culture, UAL's plan was fatally flawed from the outset. Few observations at UAL with reference to ESOPs are as follows:

- Flight attendants, the face of the company to customers, never were in the ESOP. They didn't want to make concessions, and the company and other unions were not willing to include them unless they did.
- The ESOP was set up so that in five years no further contributions would be made. New employees would not be owners, and existing employees would get no more stock. So everyone knew from the outset that the ESOP could be put in the 'this too will pass' category.
- Employees took substantial concessions for the ESOP, and bitterness over these givebacks never faded. Only 1% of all ESOPs require concessions. In fact, employees in ESOP companies generally are paid more than comparable employees in non-ESOP companies.

Source: Excerpts from an article by Corey Rosen, NCEO Executive Director

Business model: What keeps the few good ones like Southwest Airlines distinguished from the rest? How are these airlines, despite the turbulent economic times, able to project healthy figures in their books of accounts? Apart from the common factors that affect all equally, the basic and the most vital factor where they differ is the business model that they follow. Failure of business model is another major factor responsible for the fall of UAL and many other followers of the similar model in the industry. There are broadly two business models being followed in the US airline industry viz., Hub and Spoke Model and Discount Model.

Hub and Spoke model was designed to extract high fares from customers while moving them seamlessly large distances. This resulted in airport congestion, slow aircraft turnaround on the ground, and inefficient use of equipment and people. A variety of aircraft were put to use in this model leading to unbearable operational expenditures. The momentary success of this model can be attributed to boom times when leisure travelers and

especially business travelers willingly paid the higher fares. When there was a change in the customer tastes and preferences due to various factors like recession, it resulted in the gradual and significant rise in the demand for the discount model. Commenting on the UAL's business model Andy Voung says, "The Air Transportation Stabilization Board (ATSB) just didn't like UAL's business plan and target revenues that they proposed to the board in its loan application. It appeared that UAL was just pulling numbers out of the air to appease the ATSB, rather than conducting thorough reviews of their operations and providing an accurate and achievable business plan. The failure to secure the government loan was what eventually forced UAL to file bankruptcy because they had been banking on the loan to keep them out of Chapter 11. And by filing bankruptcy, thousands of people lost their jobs. Those that didn't lose their jobs have had to take big wage cuts."

Unlike the Hub and Spoke Model, labor costs at most of the discount airlines are lower. Most of the smaller discount airlines fly only one type of airplane. This facilitates in simplifying processes and curbs the cost of training, maintenance and spare parts. In contrast, United Airlines flies as many as seven types of planes leading to galloping operational costs. Forgoing the food and frills and choosing the selective route structures are other features of Discount model that facilitate these airlines in minimizing the costs and competition respectively. The choice of adopting the Hub and Spoke model over the Discount model especially in the recessionary environment meant low revenues and high costs for the company—that have resulted in reporting a poor financial performance.

Adopt or perish

There is no denying to the fact that UAL has real hard times ahead. The organization needs to implement all the possible cost-cutting measures. When asked about the current status and the future trends of UAL Andy Voung opines, "The company is on the right track after securing new labor contracts with all of its unions. They plan to launch a low-cost carrier to compete with Southwest, JetBlue, etc. Analysts hate the idea, but it could be the right thing to do at the moment. They just simply have to continue to cut costs to become profitable again. And their doing that by renegotiating airport and aircraft leases." Echoing a similar viewpoint and elaborating further, Corey Rosen says, "UAL has now renegotiated its contracts, and employees will be getting stock options, as they do now at American and US Air has been already adopted at Southwest and JetBlue (two successful airlines). Other airlines may follow this pattern, which is very interesting in the light of UAL's employee ownership problems. Clearly, the idea still has a lot of power. But UAL now has to find ways to create more of an ownership culture, to get employees more involved in generating ideas about how to perform better. At this point, I don't see that happening."

Keeping the economics, customer tastes and desires, labor problems etc., under consideration it would be prudent on the UAL's part to bid adieu to the Hub and Spoke model and stick to the cost-cutting methods. Analysts feel that many airlines including the UAL have already started implementing the discounting model though the airlines are hesitating to admit the shift in the business plan. The airways must pay special attention to the customer care so that the customers get a satisfactory air service. With the successful implementation of the above mentioned antidotes it is hoped that the UAL will witness smooth skies and a pleasant flight by the coming spring.

KBS Kumar

Reference # 1-2003-06-08

Four Correctives that Might Make the US Airline Industry More Competitive

- **Limit Code Sharing:** Code sharing means that two airlines sell tickets on each other's flights. But this practice has reached to an extent of offering overlapping flights to certain cities. This is a deliberate attempt to hurt competition. Federal Government's Justice Department requires to play a crucial role in stopping these arrangements.
- **Cutting taxes and fees** is also up to the Federal Government. When a passenger buys an airline ticket, she or he pays four charges: A 7.5% federal excise tax; a $3-per-segment tax; as much as $4.50 in facilities charges for each leg of the flight to airports; and a $2.50 charge per leg to the Transportation Security Administration (TSA) to police airports. Those who oppose these taxes can argue that flying is not a luxury for the rich, which the excise tax implies, and that passengers should not have to fund the TSA.
- **Change the way gates are controlled:** Perhaps there would not be a shortage of airport gates if the airlines that hold them were required to use them fully. Often they do not, but those gates are not made available to low-cost airlines. If discount airlines are to increase their market share, they must be given access to more gates.
- **Open US skies to foreign airlines:** Under present rules, foreign airlines cannot transport passengers between US cities, and they cannot own more than 25% of a US airline. But think how consumers might like to enjoy the service of highly touted foreign airlines like Singapore Airlines, China Airlines, and KLM Royal Dutch Airlines. And opening our markets to them might result in Europe opening their markets to us.

Source: www.epinions.com

Discussion on Cash Retention

There is a tendency of maintaining huge cash balances by some companies. Companies such as Microsoft Corp., Nokia, Infosys, Wipro and Hindustan Lever Ltd. maintain hefty cash balances. Financial prudence requires that companies should determine and maintain optimal cash balances and distribute the rest to the shareholders by way of dividends or stock repurchases. Companies believe that maintaining huge cash balances fetch them certain strategic advantages and help them mitigate the risk and uncertainty prevailing in the capital markets. What are the pros and cons of such a practice?

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Some cash rich companies are maintaining huge cash balances. Is this strategy of maintaining cash balances justified?

Jitender S Kanwar (JSK): Excess cash balances with a company, after paying off its debts and providing for its foreseeable capital expenditure plans, should be used only upon a strategic input from its shareholders. One easy temptation for the management with surplus cash is to generate fresh investment projects, or to attempt acquisitions of other entities. The fact of these plans coming in only due to surplus cash positions often cause them to be suboptimal investments from the point of view of the company's overall core strengths, or from the mandate available from its shareholders.

Ian Cooper (IC): Cash balances are like negative debt. The costs of them can be tax inefficiency, wasteful investment, and weakening of incentives for cost management. The benefits of cash balances are the flexibility to respond to investment opportunities and a cushioning against financial distress.

Murlikrishnan A G (AGM): It would be a healthy practice to share the company's cash retention and distribution policy with its shareholders so as to maintain transparency and predictability.

What factors should companies consider when deciding on optimum level of cash balance?

JSK: According to me, there are broadly two factors that a company needs to consider before deciding on the optimal level of cash balance that it should hold.

- Adequate cash for immediate working capital and investment cycle.
- Ability to maintain people costs and establishment costs if a prolonged business downtrend was to follow.

IC: Software companies are businesses whose value derives largely from intangible assets. So they should not have large amounts of debt. Their cash flow can be volatile, and the costs of financial distress large, so a certain amount of cash to cushion against the possibility of distress is reasonable. However, this does not justify holding huge amounts of cash on a long-term basis.

AGM: The single biggest factor that should determine the level of cash balance is the 'business needs'. It would be reasonable for companies to be conservative while estimating the business needs and also factor for certain unforeseen situations that would necessitate adequate availability of cash.

What are the strategic advantages and disadvantages that a company might get from maintaining such huge cash balances?

JSK: Strategic advantages are the ability to cash in on a desired (and justified) acquisition opportunity if valuation turns attractive and the

ability to initiate fresh capital projects.

Strategic disadvantages are doing the above for suboptimal returns or against core strengths; losing value if somehow its own share price is priced low in the market (in a bear phase, for instance) for the sum of its business value and asset (including cash) value.

AGM: Strategic advantages are many—comfort during a prolonged period of economic distress, addressing expansion needs in a nimble footed manner, capitalizing on sudden business opportunities that include acquisition for growth.

The single biggest disadvantage is the negative effect of huge cash on 'Return on Capital Employed' (ROCE). This is a nightmarish situation for several companies especially so when the interest rates are soft so as to dampen the 'treasury income' from deployment of idle cash.

In the wake of the ongoing criticism about cash balances, is it time to return the excess cash to investors?

JSK: Yes, the company should distribute the cash to shareholders if it cannot optimally earn returns on it. Share repurchase is a sophisticated tool to distribute it to those shareholders who prefer cash in hand, while raising the valuation of the remaining lower level equity. Also, a treasury share repurchase option will provide a convenient liquidity and valuation management tool. Tax considerations in the shareholders' hand may however justify a dividend distribution.

IC: Excess holdings of cash should be returned to shareholders. My colleague Prof. Henri Servaes has recently estimated that, at the end of 1998 the largest corporations around the world held $1.5 tn of cash and cash equivalents. This was about 10% of the value of their equity. This average figure means that some corporations are holding huge amounts of cash. I can think of no plausible reason why this level of cash holdings is in the interest of shareholders.

Whether it is better to distribute it through repurchase or a special dividend is mainly a matter of the relative tax treatment. In general, in classical tax systems, such as that in India, repurchase is more tax efficient. Repurchase also has certain side-benefits, such as not reducing the unit share price, which is important if the incentives of share option schemes are to be preserved.

AGM: Subject to adequacy of profits and reserves 'dividend' is the easiest form of distribution and in the current context would also be tax efficient for the company and its shareholders. However, in the case of listed companies, it would also be possible that share repurchase form of returning cash could be more tax efficient. It is sufficient to say that the methodology would largely depend on the individual situation.

There is an argument that even large and reputed companies need to maintain huge cash balances to avoid the risk of not being able to access capital markets when needed?

JSK: This argument would tend to test the efficiency of the markets. If raising fresh funds were a fear, then its valuation even with excess cash in hand would be suppressed. This company would then quite likely not be trusted on its fresh capital expenditure returns in any case. (This assumes the real need for the cash to be quite far away.)

IC: The idea that access to capital markets is denied to companies with good investment opportunities on any kind of regular basis is, in my opinion, not true. Even when capital market conditions are difficult, large companies with good investment opportunities can generally raise capital. In my opinion, very large cash holdings seem to protect companies against a shortage of capital at times when they are not viewed by the market as having the right kind of investment opportunities. This does not strike me as a value maximizing motivation.

AGM: To an extent this argument is true and acceptable. However, in the long run it would be advisable to establish a good track record of returning cash to shareholders. This approach would help create a differentiator which in turn would help a company to successfully access capital markets at all times.

To what extent the current low interest rates are responsible for the tendency to retain large cash balances?

JSK: Impact of low interest rates should be limited, and rather contrary. More relevant explanation may reside in the simultaneous downturns in both the share markets and business outlook.

IC: In last 10 years, nominal interest rates have been low and equity markets have, until recently, been high. These have been good times for companies to raise money. For much of the period, corporate cash flow was also quite strong. Large cash balances arose from this combination of circumstances. If companies adopted aggressive share repurchase programs, we would not see such large balances, but they are reluctant to do so.

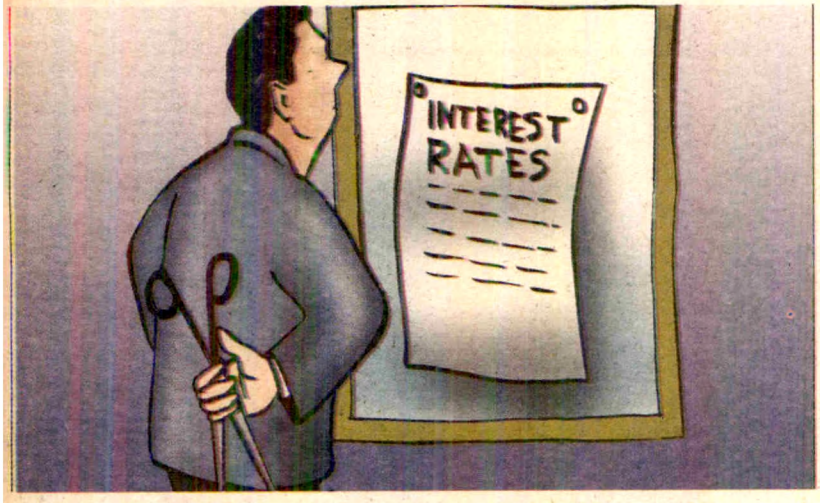
AGM: On the contrary, the current low interest rates would in the near future hasten return of cash to shareholders, which would help companies to get their ROCE back to shape.

Coordinated by Sharath Jutur

ECB

Extra cautious banking

The European Central Bank has cut interest rates by a quarter of a percentage point to spur growth. Critics, however, question the adequacy and ability of the cut to revive Europe's sluggish economies and suggest that the bank might as well follow Greenspan.



After months of dithering, the European Central Bank (ECB) finally bit the bullet. The ECB announced on March 6, a 25-basis point cut in interest rates thus bringing the benchmark rate down to 2.5% at its three-year low. However, outside the bank's Frankfurt headquarters, the consensus remains that the move has been far too slow. The critical point of debate: Is the cut deep enough to stimulate the euro area's flagging economies, and if not, will the ECB be ready to cut again? The general verdict on the latest cut seems to be necessary but not sufficient. Euro land's economic problems are now so acute that a larger short-term monetary stimulus may be needed to prevent, at best, stagnation, and at worst a slide back to recession.

The latest cut—the first since a 50-basis point cut in last December—was widely expected given the precarious state of the euro area's economy. Considering the ECB's long-standing reluctance to match other central banks in reducing the short-term interest rates, it would be unwise to expect for a larger cut. However, this rate cut has also brought into picture a new debatable dimension—whether the substance of ECB's policy is misguided? This allegation comes mainly on account of inconsistencies in what the bank says and what it does. The ECB's repeated emphasis on the need to keep inflation below its target of 2% has often been at odds with its decisions to reduce interest rates when inflation has gone above target. This is substantiated by a report from the London-based Centre for Economic Policy Research (CEPR). The findings of the report suggest that, in spite of the ECB's rhetoric, there is a negative correlation between monetary growth and interest rates i.e., when money growth rose sharply, the ECB has shown tendency to reduce interest rates and vice versa.

Growth initiatives – Is the onus completely on ECB?

The economists and other central bankers have long been pressing for rate cuts by the ECB. The obvious reason being the gloomy growth prospects in the euro area. America is struggling to recover from its recession and it is feared that it might slip back again into recession while some economists are claiming that recession is already under way. The Iraq war would further hit the consumer confidence and curb consumer spending which in turn would accelerate the downward trend. Japan seems to be hopelessly tied up in its own economic malaise. Given this situation, now if Europe does not take growth initiatives along with others, it would complicate the global economic outlook with all the three engines of grow-th failing and this would be a huge burden to contend with. Many quarters have been suggesting that the ECB emulate the Fed in framing the monetary policy with specific focus on the way Fed is strategizing a recovery in the US. The sustained rise in the value of the euro, especially against the American dollar, has added urgency to the economic case for a larger growth stimulus from the Central Bank. Economic circles reckon that whatever benefit the rate cut might bring will be far less to offset effects of the rise of the euro. A higher exchange rate tends to have the same dampening effect on inflation as a rise in interest rates. But a rising euro will also have an impact on growth prospects. For instance, there is some evidence that in Germany, export demand has weakened as the euro has risen. A strong currency might make central bankers and politicians feel better, and it might also help bear down on inflation. But it makes life even harder for exporters competing in what are already

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difficult international markets. If the euro continues to strengthen, and the euro area economies continue to weaken, there will be then no excuse for inaction. The Central Bank's reluctance to cut rates has often been contrasted with the aggressive enthusiasm for rate cuts shown by the Fed in the past two years. However, drawing too many parallels with US can be misleading and this is precisely the ECB's contention against the prevalent views of emulating Fed in easing of interest rates.

The American economy is more deregulated, with more flexible labor and capital markets—it has fewer of the rigidities which have hampered the euro area and which the European governments have been surprisingly reluctant to tackle since the creation of a single currency. The ECB's governing council remains reluctant to accept that the bank has a role to play in fostering growth in the sluggish euro area and the Central Bank's message seems loud and clear to the euro nations—clean up the fiscal mess to facilitate growth. ECB has been urging euro area governments to push through the structural economic reforms that would make economies more flexible to kick-start economic recovery and not just depend on the interest rate cuts to do the trick. The bank claims that its inflation target—2% or lower—is the sole determinant of interest rate policy. The ECB has long been pointing out to the euro area governments that they are violating their own budgetary rules—several currently having deficits above the permitted limits. While the euro area's budgetary rules—The Stability and Growth Pact—remain controversial, the ECB is right to point the finger at the political failure to deliver economic reform. This is especially true about the biggest European economy—Germany, which once again seems to be on the brink of recession and unemployment is back up to more than 11% on an unadjusted basis. The ECB is right about the need for reform and it is hard not to sympathize for the beleaguered Central Bank. After all it is a relatively new institution, still finding its feet and trying to establish its credibility with the financial markets in an unexpectedly difficult international environment.

Structural differences

Against the backdrop of all these arguments let us try to differentiate the US and Europe structures to understand the ECB's stand.

Fiscal system: The euro area in aggregate is approximately of the same size as that of the US. Barring the intra-trade activities, the international trade of both the economic entities account for around 10% of the GDP. However, the fiscal policy framework differs for US and euro zone. In the US, the greater part of the fiscal system is centralized under the federal system, which provides long-term transfers from richer to poorer regions and provides a degree of 'automatic' fiscal stabilization. By contrast, the centralized budget of EU is miniscule (about 1.27% of EU output) and there is minimal amount of fiscal transfer within the EU nations. Thus, the central budgets provide almost no automatic stabilization as countries fluctuate with respect to each other. However, this does not mean that the stabilizers are absent in the region. In fact, they are much larger than US as the average rates of taxation are higher in EU and the tax system is more progressive.

Labor market: Another area of comparison is the labor market. In the US, the labor market acts as a single entity whereas in EU the labor markets belong to each participating country and hence cannot be thought of as one entity. In the US, labor mobility is higher than EU where inter-country mobility is limited due to language and culture differences. Also, the wage bargaining systems differ between the European nations (e.g., in the degree of unionization and coordination). These factors result in wide variation in the wage levels within the EU. For example, in 2000, the hourly compensation in Germany was $24 while it was $4.75 in Portugal.

The Reaction Function approach: Most consensus models of economy have a simple structure. Broadly speaking these are of 'natural rate' type with the path of productive potential unaffected by the macroeconomic policy. However, in the short-term the output and employment are affected by aggregate demand. A non-zero output gap or unemployment gap determines the level of inflation in the economy—The Philips Curve Effect. For example, if output is below potential while the unemployment is above the natural rate, it would lead to falling inflation and vice versa. Any macroeconomic policy has two principal roles—controlling inflation and maintaining stability. Stability refers to stabilization of output by keeping it close to its potential while stabilization of employment by keeping it close to its equilibrium level. The new consensus macroeconomics delegates these two functions to the central banks and it is embodied in any central bank's 'Reaction Function'. This term effectively encapsulates the dual specification of a central bank's medium-term objectives and set of reactions that are called into play when, due to shocks, the economic variables deviate from their desired path, particularly inflation. A particularly simple reaction function which is generally used in the discussions of monetary policy is—The Taylor Rule—which relates short-term interest rates to percentage deviation of inflation from target and percentage deviation of output from potential according to the equation:

$$R = Rn + 0.5 (\pi - \pi^*) + 0.5 (y - \bar{y})$$

where,

R = Real Interest Rate;

Rn = Neutral Interest Rate;

$(\pi - \pi^*)$ = Deviation of Inflation from the target;

$(y - \bar{y})$ = Deviation of Output from the potential.

Hence the reaction function is a feedback mechanism of central bank's inflation responsibilities in medium-term at minimum cost in terms of stability in the short-term. Some reaction functions are implicit like that of the Fed while some are explicit like that of ECB and UK. In the US, the 'Greenspan Reaction Function' has never been explicit but has come to be reasonably predictable and transparent. The Fed has dual responsibility of targeting inflation and maintaining growth. In Europe, the ECB has defined its inflation target of 0-2% p.a. but other aspects of its reaction function are less transparent. As per its own admission, it is concerned only with inflation targeting. Under inflation targeting the central bank targets inflation and accordingly moves short-term interest rates to meet the target over the medium-term. Probably on these grounds the ECB shirks the responsibility of stability and hence growth. However, this does not have to be the case as it contrasts with the specification of Taylor Rule, which gives equal weights to deviations of inflation from target as well as output from the potential. In case of inflation targeting regime there certainly is the question during adjustment, of what weight is to be attached to output deviations and inflation deviations, but it is certainly not the case to ignore output, employment and growth. Without doubt, framing of monetary policy is far more difficult in practice than in theory as the term refers to the set of contingent behaviors in the face of different shocks hitting the economy. Moreover, it is the reaction function perceived by the private sector and financial markets, which is important. The objectives of the monetary policy should be clearly specified which would enable anticipation of the likely reaction of the system in the event of wide range of circumstances. These aspects of ECB's monetary policy in the euro area seem to be less well established than the Fed's monetary policy because the 'Greenspan Reaction Function' appears to be clearly understood, even though, it is hardly specified in formal terms. These aspects are important because expectations affect consumer and investment expenditure as well as financial market prices. Any economy, which embodies the belief that contingent action will be taken, is likely to be more stable and resilient. And hence, economists suggest that a successful institution in inflation targeting regime should do three things: (a) It should lead to expectation that inflation is under control; (b) It should lead to anticipation that growth, in the medium-term, will be at potential; (c) It should lead to anticipation that output deviations and inflation deviations will be minimal given the shocks hitting the economy. Inflation targeting, if successful, should stabilize expectation of inflation and growth.

Without doubt, framing of monetary policy is far more difficult in practice than in theory

Fiscal issues

Over and above these issues' probably the most important issues that concern the ECB while framing its monetary policy are the fiscal issues of the EMU and this includes the Stability and Growth Pact (SGP). The countries comprising of the euro area today entered into this pact prior to the event of the euro coming into existence with the intention of imposing some medium-term fiscal rules on the participating nations. This was required because the fiscal authorities were decentralized. The SGP required that the fiscal authorities of the participating nations aim for government deficits 'to be close to balance or in surplus'. The SGP imposes 'one-size-fits-all' fiscal policy on euro area countries. According to the pact, deficits of more than 3% of the GDP are forbidden whereas there isn't any equivalent limitation on the surplus. The criticism about the pact has been that if the growth rate in the euro area becomes weak, then the pact would put stress on the euro nations to fulfill the criteria. And it seems, this is just what has been happening in the euro area in the current scenario. The pact seems to be unfair for nations with high levels of taxation and these would be the first ones to breach the pact given the bleak economic scenario engulfing the euro. Given the current global economic environment Europe's problems are piling up fast. Its economies are struggling to regain momentum, and Germany is on the brink of another recession. Several countries are now set to breach the budgetary guidelines i.e., The SGP. The pact has been in for criticism from several circles of economists, right from the onset and last year, even the President of the European Commission, Romano Prodi, described the stability pact as 'stupid'. There are signs that the commission will soon formally propose substantial modifications to the pact. These might include making it easier for countries with sound public finances to have more fiscal flexibility, while tightening the constraints on those tempted to behave irresponsibly. Although such modifications might help avoid future problems, they will do little to address the current disarray.

The Commissioner of European Commission, Pedro Solbes, put forward some proposals to reform the budgetary rules as per the need of the hour. These proposals mainly revolve around improving the SGP

through proper accounting of public investment. Some of the proposals that are likely to be considered this spring are:

- The deficit relevant for the pact should no longer be 'structural' budget deficit but the 'structural' deficit. Thus, increases in deficit resulting from economic slowdown will be ignored. This will particularly please the Keynesians as they advocate that the governments should indulge in deficit budgeting to help turnaround the economy.
- In assessing the nations' compliance with the SGP, the commission will take into account the impact of structural reforms such as the tax reforms or government investment in public infrastructure. However, this will be applicable only to countries where (a) government debt is below 60% of GDP; and (b) public finances are on a sustainable footing after taking into consideration the outstanding public debt, contingent liabilities and the costs related to social security benefits.

The rationale behind introducing measures for proper accounting of public investment mainly stems from the expectation that it would be widely accepted. This is because it draws parallels between the private sector and the public sector. A private company does not attribute the entire cost of an investment project to a single year's accounts but distributes the cost over time as the returns from the investment accrues. Hence, if the proposals are accepted then amortization of investment expenditures by the government will be allowed. The correct accounting of public investment will remove financial constraints on public investment and introduce more transparency in budget. These factors will in turn help sustain the aggregate demand in the euro area, which is critical to revive the economy.

New challenges

Apart from these issues, the EU now finds itself with a new distraction-enlargement. Ten new countries, mostly from Central and Eastern Europe, are set to join in May 2004—and applications for others to join later are pending. Politically, enlargement is an important step in the process of integrating the former communist states into the global economic and political system and in consolidating democracy. However, this is not without its share of problems and the economic and social difficulties in the integration are going to be substantial. The potential for the free movement of goods, labor and capital across 25 countries, at widely different stages of economic development and at different levels of integration into the European economy, will force big changes in the way the EU functions as an economic block. This means as the EU expands, the institutions that run it will have to change fundamentally if the Union has to survive.

Given these circumstances, the ECB has to radically alter the way it has been functioning. All things said and done, primarily it should check the unspoken message that it has been communicating to the world about the monetary policy having lost its edge in controlling euro area economy. Instead, it should work on improving its transparency about its reaction function. Definitely the ECB's concern about the weakening commitment to fiscal discipline among governments is valid. This is more so when we consider that the SGP has been meeting with increased resistance from European states. Among the large economies bumping up against the 3% deficit limit, France has been hinting that it will not try to stay within the permitted range and Germany looking to follow the suit too. The stern line from the ECB justifying its reluctance to cut rates to spur the growth of these economies is that these governments should not have squandered the opportunity to impose fiscal discipline in the good years. Having said that, the ECB also believes that neither fiscal discipline nor well-judged monetary policy is enough to solve the problems faced by Europe's economies, and above all by Germany. The ECB enjoys broad support for this view that structural reforms are urgently needed, to make labor markets more flexible and to curb social welfare costs.

Throughout the 1990s the American economy outpaced the EU's growth by growing at approximately 3% every year, a pace the EU never matched once. In response to this, the European leaders have resolved to produce the "most competitive and dynamic knowledge-based economy in the world by 2010". Unlike other EU targets, however, this one cannot be achieved by administrative fiat: Europe's economy is still growing far more slowly than the American, while most of the EU countries' leaders remain reluctant to undertake the painful structural reforms to make faster growth possible. The euro governments are trying to perk up their economies by announcing new package of measures intended to stimulate the economy. However, the fiscal measures would bring in the desired effect in the medium to long-term while to bring about short-term relief the ECB has a major role to play. Hence, rightfully, the economists have been arguing that despite the time it takes to work through economies, monetary policy is the best short-term bet to kick-start the economic revival in the euro area. Hopefully this argument convinces ECB to take up responsibility to foster growth in the euro area as now even the Iraq war threatens the economic revival globally if the American estimates go wrong.

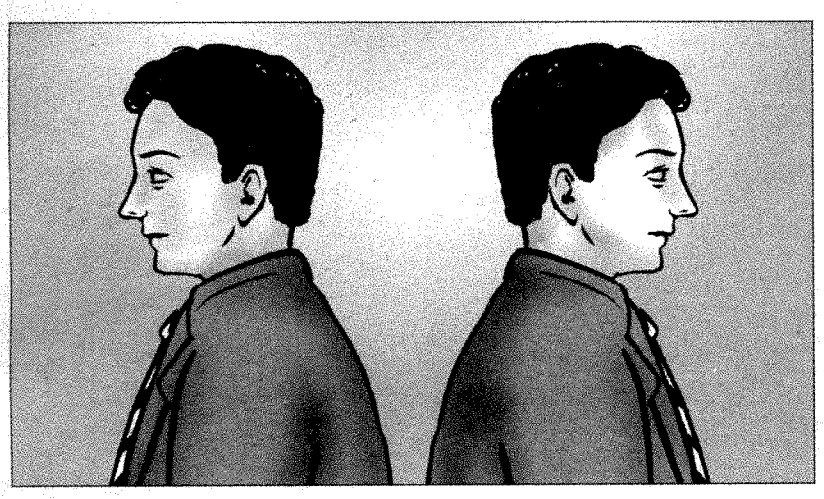
Aniruddha Kekatpure

Reference # 1-2003-06-09

INTEREST RATES IN EU

On a different footing

Depending on the economic condition of a region, it makes sense to lower interest rates. From this point of view, one cannot entirely blame the strategy that the ECB is following, says Nilanjan Banik, Department of Economics, Utah State University, USA.



The objective of any nation or for that matter any economic union, like the European Union (EU), is to foster economic growth. Unfortunately, continued growth, although desired, is not always achievable. Problems come when the economy is facing a recession. In a recession per capita availability of output is lowered, which lowers the economic growth of a region.

Given the fact that no one likes a recession, policy makers use stabilization policy to contain it. Stabilization policy can be pursued through monetary policy, fiscal policy, or a combination of both. Although it is easy for a single country to follow a stabilization policy, it is quite hard to implement one stabilization policy for many countries in one economically diversified region, like the EU. For example, if one country within the EU faces economic expansion versus another which is facing recession, then stabilization policy requires a contractionary monetary policy for the former whereas an expansionary monetary policy for the latter. However, given that both the countries are members of the EU, it is not possible to implement two different policies at the same time.

A way out of this problem is to ask the member countries to follow certain macroeconomic convergence criteria. The Maastricht Treaty specifies that EU member countries must satisfy several macroeconomic convergence criteria before becoming a member. These are:

- The country's inflation rate in the year before admission must be no more than 1.5% above the average of the three EU member states with lowest inflation.
- The country must have maintained a stable exchange rate without devaluing on its own initiative.
- The country must have a public-sector deficit no higher than 3% of its GDP. And,
- The country must have a public debt that is below or approaching a reference level of 60% of its GDP.

In addition to these criteria, all the member countries should have a common currency and a common monetary policy; that means the same rate of interest within the EU. The idea is to put the economically diversified members, more or less, on the same platform, so that stabilization policy becomes successful.

Implementing a stabilization policy using monetary policy requires targeting inflation rates and interest rates (as an intermediate monetary target). Targeting means fixing inflation rates or interest rates within certain pre-specified bands. The European System of Central Banks (ESCB) conducts monetary policy for the EU. ESCB is comprised of the European Central Bank (ECB) and the National Central Banks (NCBs) of the countries that participate in the European Monetary Union.

The ESCB is sometimes reluctant to cut interest rates. This happens because the relatively economically stronger members do

not want that to happen. A lower interest rate implies an outflow of foreign capital from the region, which none of the booming economies will support. So depending on the economic condition of the region, it makes sense to lower interest rates. From this point of view, one cannot entirely blame the strategy that the ESCB is following.

This brings us to the second option of targeting inflation. This policy has been quite popular in the UK. A problem with higher inflation is that it makes real exchange rates depreciate. Countries like Germany, having a stronger domestic currency, will not like other members in the EU to follow a budgetary deficit. This would weaken the purchasing power of the Deutsche Mark.

At a time when an economy is facing a recession, expansionary monetary policy can be an effective mechanism to fight it

There are two ways of reducing inflation. The first involves a sharp reduction of money supply in the economy. Better known as 'cold turkey' policy in literature, it tries to cut the inflation rate fast. This method of reducing inflation was followed in the UK during 1980s and 1990s. The other is the 'gradualist' policy, where the Central Bank gradually tries to reduce the inflation rate by slowly reducing money supply.

The benefit of the cold turkey policy is that it is more credible. People forming their expectations rationally are more likely to believe that the policy has changed under the cold turkey strategy than under gradualism. A credible policy is one that the public believes will be maintained and will succeed.

However, there is a problem associated with it. Going by the Phillips Curve hypothesis, inflation rates and unemployment are inversely related. A drastic reduction in inflation rates will eventually lead to more unemployment; going against the growth perspective. So, targeting inflation in the cold turkey fashion is not always going to be beneficial.

The fiscal responsibility charter, as mentioned before, aims at placing different economies on the same platform. A major cause of disruption in economic activities results from uncertainty. Many economic decisions depend not only on what is happening today but also on expectations of what will happen in the future. For example, in response to lower present sales, firms alter their investment plans in the hope that there will be less to sell in the future. An economic benefit from following common fiscal and monetary policy along with fixed exchange rates is that uncertainty is reduced and a more predictable basis will be provided for decisions involving international transactions.

The costs arise because a country joining a common market gives up its ability to use exchange rates and monetary policy for the purpose of stabilizing employment and output. At a time when an economy is facing a recession, expansionary monetary policy can be an effective mechanism to fight it. This happens in two principal ways. First, the real interest rates (nominal rates of interest less inflation rates) fall. Second, under flexible exchange rate regimes, when exchange rates depreciate.

All investment decisions in the economy are based on real interest rates. With expansionary monetary policy, real interest falls in the short run. This happens because in the short run nominal interest rates fall whereas both prices and wages, which are sticky in the short run, do not change. One reason why prices do not adjust immediately to clear markets is because adjusting price is costly. To change prices, a firm may need to send out a new catalog to customers, distribute new price lists to sales staff, or for restaurants and print new menus. These costs, better known as menu costs, cause firms to adjust price intermittently rather than continuously. Price stickiness may also result from coordination failures among firms. For example, in a recession, if one firm reduces price and other firms do not, there may be no way for the first firm to recoup its loss in revenue resulting from a lower price. As a result no individual firm would like to cut down price even when it has information about a recession.

Hence, real interest rates, defined as the nominal rate of interest less rate of price change (inflation), falls in the short run. This leads to an increase in investment and hence employment and output in the short run.

Coming back to the exchange rate factor, an expansionary monetary policy will encourage capital outflow from the economy by lowering nominal interest rates. This results in depreciation of domestic currency. With capital outflows the relative supply of domestic currency falls vis-à-vis foreign currency. Depreciation leads to higher import prices and lower export prices. Ultimately, the increase in exports brings the much desired result of an increase in output and employment.

Hence, in some sense, the euro area's fiscal responsibility charter is imposing some restrictions on the stabilization policy but at the same time it is helping by reducing the uncertainty factor.

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Reference # 1-2003-06-10

RETAIL INVESTING IN INDIA

Channelizing growth

India has been able to achieve significant economic growth in the last couple of years. However, it was mainly because of the performance of some sectors. In order to achieve and sustain higher levels of growth, retail investor participation should be encouraged.

For the speedy growth of any national economy, it is important to have the right kind of policy and involvement of the population. While many of the developed countries prospered due to the active involvement of retail investors, India has not been able to grow at the same speed in spite of the fact that it enjoys highest savings rates. Many a times this has perplexed the policy makers as what will make the retail investor participation in the economic growth more efficient.

During recessions, economies look towards retail demand and investment patterns to analyze the chances of revival. Right from economists, fund managers, banks, insurance companies to the government discuss about the retail investment and essential financial sector reforms to increase investments. This is the common phenomenon and India is no exception to this. Though Indian economy is in a comfortable position on some important parameters, the level of retail participation in economic growth is abysmally low.

At present India is facing a paradox. It is having capital account deficit and current account surplus, thanks to the services sector (IT & ITES). In spite of the fact that inflation is under check and forex reserves are at all time high, economy is not growing at the desired rate. It is realized that India has the potential to grow at much higher rate. It is also recognized that the "current rate of growth of 5 to 5.5% will not help India just as the 'old' rate of 2.5% did not. In order to make a visible impact, India would need to grow at least at the rate of 8% per annum. In his remarks, Rakesh Mohan, Deputy Governor, Reserve Bank of India, is of the view that policy makers in India were well aware of the issues that needed to be addressed, however, there were difficulties taking action quickly. Reforms are needed and a three-pronged strategy has been designed (The Indian Economy – A Perspective, 8th Asia Forum Meeting, Frankfurt, November 7, 2002) to address all the issues simultaneously. The reforms are aimed at boosting investment in the economy, focusing on key sectors and increasing productivity of investment.

Economic rationale

Economy of any country consists of numerous entities, which are vital for smooth functioning of the economy. Each of these entities has a specific role to play. Broadly, there are three entities in the economy viz., household, corporate (private and public sector) and government. All the sectors, at some point of time, are either with surplus funds or have deficit. Surplus entities play an important role by supplying fund to the deficit entities. Businesses borrow funds for capital expenditures whereas government borrows for public spending and other vital purposes. The way in which various sectors supply funds to the capital markets are like-wise linked. It is a known fact that most of the funds that are supplied to the market come from individuals or the retail sector since corporate usually plough back their earnings. Government can also be a supplier of funds at times.

One of the basic preconditions for the growth of an economy is the growth in capital formation. Capital formation implies diversion of productive capacity of the economy to the making of capital goods that increases future productive capacity. It is generally referred to as increase in the stocks of material capacity only. The process of capital formation thus involves three distinct yet interdependent activities, viz., savings, finance and investment. As the size of national income increases with increase in productive capacity, the volume of savings generally increases, unless the MPS (Marginal Propensity to Consume) is either equal to or higher than the average propensity. It is a well known fact that private and government savings are limited in scope. In such a case the individual savings becomes important. These individual savings are influenced by a multitude of social, psychological and political factors. The economic factors, specifically the level and distribution of income, fiscal, monetary and economic policies are also important, as they drive the main factors.

Out of three activities that are important for capital formation, finance forms a vital activity of routing the savings to investments so that capital formation takes place, thus leading to economic growth. This routing brings financial intermediation into picture. They facilitate flow of funds from surplus to deficit sectors. They are financial units and their main function is to manage the financial assets of other economic units. They borrow funds through issue of financial asset securities and re-lend the funds it raises. Most accepted financial intermediaries

Household Savings and Investment Trends (% GDP) Current Data Required					
% of GDP	1993-94	1994-95	1995-96	1996-97	1997-98
Currency	1.6	1.7	1.5	1.1	0.9
Bank deposits	4.5	5.8	3.6	4.5	5.8
Non-bank deposits	1.4	1.2	1.2	1.7	0.5
Life insurance	1.2	1.2	1.2	1.3	1.4
Provident/pension	2.2	2.2	2.0	2.1	2.3
Small savings	0.9	1.4	0.9	0.9	1.6
Shares and debentures	1.2	1.4	0.8	0.5	0.2
UTI units	0.6	0.4	–	0.3	–
Trade debt	(0.1)	(0.1)	–	–	–
Total % GDP	13.5	15.2	11.2	12.4	12.7

Source: Indiainfoline.com

that are operating in our country are banks, investment companies, insurance companies, Development Financial Institutions (DFIs), Non-Banking Finance Companies (NBFCs), Mutual Funds (MFs), pension funds and some quasi-government agencies. All of them perform various kind of intermediation viz., denomination intermediation, default risk intermediation, maturity intermediation, liquidity intermediation and information intermediation. They also provide risk pooling and diversification. They benefit through economies of scale and scope. On the other side, the retail investors, having small amounts, are risk averse, having different maturity profiles and who lack vital information and expertise, invest in the financial claims raised by them. All of these intermediaries have different kind of operation and different regulators.

Though retail sector has not received considerable attention in the past, it is slowly gaining momentum. Sandesh Kirkire, Head, Debt Fund, Kotak Mahindra Mutual Fund Limited, explains the economic rationale behind the shift in perceptions when he says, "The economy continues to have a high capacity in most of the sector. Most of the corporate today have become very efficient. Many of them operate at negative working capital having improved efficiencies across the manufacturing process. The banking sector continues to carry the stigma of high NPAs making them more risk averse. In fact, it is because of this that you see most of the banks increasing their retail lending focus. The huge middle class of the country continues to be an attractive proposition for the banks."

Trends in retail participation

Recently RBI, the Central Bank of the country has opened the G-Sec gates for the retail investors. According to Sandesh, "This could be to offer retail investors a complete credit risk free asset. However, the G-sec market is really a wholesale market with the trading lot being that of Rs. 5 cr. Thus, a retail investor does not get inter-bank rates and has to pay a premium. He believes that the same initiative of getting more retail investors access the gilts could be more effectively achieved by promoting the Gilt Funds."

Other intermediaries have also recognized the potential of retail investment. There are various kinds of financial claims that are issued by these intermediaries. It must be noted that there are few tradable instruments available for investment by retail investors. Most of the available products are different kinds of schemes that are largely illiquid.

The investment in any of the financial claim is governed by certain considerations. It ranges from return, safety, and liquidity to maturity. Different class of investors has different profile, which makes the intermediaries to design specific instruments for these classes. Table 2 shows the level of retail participation in different categories of investment avenues.

The tables indicate the importance that the typical investor attaches to 'fixed' return schemes and the extreme importance and faith in the 'government' as a borrower. This shows the importance of safety in any profile of retail investor. Also, the investment in the fixed income securities is on a rise and in shares is on a fall. The share of household sector in the capital markets (through shares and debentures) has fallen to around 2.7% in 2000-01 from as high as 13.5% in 1993-94. This reflects loss of confidence in above instruments of private sector corporate. It has come down to 1.3% in 2000-01 from as high as 8% in 1993-94. Also, there is a marked change as the share of non-UTI mutual funds has gone up to 1.8% in 2000-01 from 1.2% in 1993-94. In fact, during last few months mutual funds have mobilized much more than all scheduled commercial banks taken together. This proves that confidence (that UTI has lost) plays an important role. UTI did not do anything to restore the confidence of the retail investors that pulled everything down. This has brought down the retail participation in this sector. Sandesh opines, "Mutual funds are the most attractive to investors who have already utilized their small savings tax limits. As the mutual funds grow in size, I am sure you would see the mutual funds bringing schemes ideal for retail investors." He further explains, "Kotak Mahindra Mutual fund (KMMF) has been coming out with innovative products for retail investors.

Recently KMMF has introduced a life insurance option in K-bond deposit scheme. This offers the retail investor a return of an income scheme in addition to an insurance cover up to Rs. 15 lakh at no extra cost." This also justifies the rush of the banks for the retail pie. Retail assets diversify the risk of the banks. Further, with a lack of corporate credit pick-up and the existing NPAs in the system, and a corresponding growth in the home loan industry on the back of tax benefits, banks find it more attractive to build retail asset book.

The flow of funds to capital markets is very important as it increases productivity and productive capacity. This can be illustrated by taking the example of IT sector which is till now among the favorites of the retail investors. The hopes are still on. The confidence shown by the retail investors in this sector has not only made this sector flourish but also has made the country an IT superpower. The same story should be repeated by the core sectors of the economy. Country like China has proved the moot point in question. It has recognized the potential and made arrangements so that the retail investors should flock to the markets. The process has already begun. India is trying to move from a regulated to liberalized financial markets with emphasis on prudential norms. All this is to restore the confidence of retail investor in the financial markets, so that the investor and the economy should get benefitted from such participation. There should be stress on three issues which could ensure a stable financial system: Well capitalized banks, better corporate governance and progress towards international accounting standards, especially towards principle-based accounting as in the UK rather than rule-based accounting practiced in the USA. There is an acute need of incorporating transparency norms (disclosures) and risk management practices. A recent study conducted by global consulting firm, PricewaterhouseCoopers (PwC), questions the risk management capabilities of most mutual funds in the country. Such a step would instill confidence in the intermediaries which play an important role of fund collection. Issues related to investor education, grievance redressal and brokering houses are much talked about but there is a laid back attitude. One measure is exclusion of hedge positions from the ambit of position limits. As derivative markets are at the nascent stage, it should be strengthened as soon as possible, by framing guidelines and rules suitable to the investors and authorities. Here could be various other issues which could crop up on a detailed study.

Household Savings and Investment Trends (% Total Investment) Current Data Required					
% of Financial Assets	1993-94	1994-95	1995-96	1996-97	1997-98
Currency	12.2	10.9	13.2	8.7	6.9
Bank deposits	33.1	38.4	32.0	36.4	45.6
Non-bank deposits	10.6	7.9	10.6	13.6	4.3
Life insurance	8.7	7.8	11.1	10.3	10.8
Provident/pension	16.6	14.6	17.8	16.7	18.1
Small savings	6.3	9.1	7.7	7.4	12.4
Shares and debentures	9.2	9.3	7.1	4.3	1.7
UTI units	4.3	2.7	0.2	2.4	0.3
Trade debt	(1.0)	(0.7)	0.3	0.2	(0.1)
Total	100.0	100.0	100.0	100.0	100.0

Source: Indiainfoline.com

> **"The economic growth can get a boost with more retail spending. As a country we have been having a very high savings rate but we have a very low leveraging at the retail level."**
>
> **Sandesh Kirkire**
> *Head, Debt Fund*
> *Kotak Mahindra*
> *Mutual Fund Limited*

Explaining the importance of retail investor in the growth of the Indian economy, Sandesh feels, "The economic growth can get a boost with more retail spending. As a country we have been having a very high savings rate but we have a very low leveraging at the retail level. With all around overcapacities in the manufacturing sector we can see additional capital spending only when the retail investor comes out and buys the goods. The tax benefits given on the house loans have seen a large pick-up in the home loan market. This was further aided by the low interest rate environment. I think the Government should continue with the tax benefits on the home loans as growth in housing industry could lead to an overall pick-up in the base commodities."

There are numerous examples that are available to cite the growth that resulted from retail participation. This is possible by taking cues from such countries and implementing the measures which suit our country. Sustained reforms combined with patience and transparency would enable India to unlock its growth potential and pave the road towards becoming a global superpower.

Amol Kshirsagar

Reference # 1-2003-06-11

JOHNSON & JOHNSON

The juggernaut rolls on

At a time when its competitors found the going tough owing to an adverse business environment, the J&J juggernaut marched ahead. However, the company faces certain challenges—discovering blockbuster drugs and potential acquisitions.

There may not be many companies around who successfully weathered the wear and tear of business cycles for as long as a century. One name that emerges strongly among a handful of long surviving business enterprises (comprising GE and Corning) is Johnson & Johnson (J&J). For those who are familiar with brands like Band-Aid, Savlon and Nizoral, J&J may not be an unknown name. The company which traces its roots to James Johnson and Edward Mead Johnson, who founded the company in 1887, in New Jersey, USA, has over the years grown into a diversified conglomerate. Today, the company, which deploys over 100,000 employees worldwide, boasts of a business empire comprising of 200 operating companies spanning across 54 countries with marketing operations in 175 countries.

However, bigness (of size) has not been a burden on the juggernaut, which has continued to roll on, dishing out double-digit earnings growth for now almost about two decades, unhindered. This is something rare in today's turbulent business environment. What has kept J&J rolling despite the general economic slowdown worldwide?

An unhindered growth

With an annual sales of $36 bn in 2002, J&J is ranked as the world's largest and most diversified healthcare company. The credit for the company's unparalleled success goes to four factors—a focused approach to research & development, an acquisition-led growth strategy, customer care, and above all leadership—which have been the key to what J&J today is. The company's aggressive approach to R&D has seen it coming out with an impressive list of blockbuster prescription drugs over the years. The company's continued focus on R&D and its ability to spot potential acquisitions has helped it to sustain growth at a time when its peers suffer as several important drugs are either patents on most of the blockbuster drugs are expiring or are on the verge of that. At the end of 2002, the company's R&D spending stood at $3.6 bn in 2001, that is equal to 10.9% of its overall sales. To quote the words of William Weldon, the current CEO of the company, "The key to our long-term consistent performance is our ongoing investment in science and technology."

This sustained focus has resulted more than 90 different prescription drugs, contraceptives and veterinary products. The list includes some of the fast-growing product lines developed or acquired in recent years such as Remicade – anti-inflammatory, Risperdal – anti-psychotic, and Procrit – anti-anemia drug, the LifeScan home glucose monitoring system, the Cypher and BX Velocity coronary stents. Besides, the company also holds leading positions in growing medical device and diagnostics lines. These include older items such as wound closure products, surgical accessories and orthopedic products, as well as newer products such as coronary stents, angioplasty catheters, and disposable contact lenses. No doubt, the drug major's commitment to innovative healthcare products has resulted in consistent financial performance with a record—70 consecutive years of sales increases and 41 consecutive years of dividend increases.

However, in order to maintain the growth tempo, the company has also relied significantly on acquisitions. Over the past decade, the healthcare giant acquired 52 businesses, spending around $30 bn. This acquisition-led growth has so far paid off well, with acquisitions contributing about 10–15% of its top-line growth annually. The company continues to pursue that strategy as it got into an agreement recently to purchase Scios, Inc., a biopharmaceutical company with a marketed product for cardiovascular disease and research projects focused on auto-immune diseases.

Earlier during the first quarter, in the current year, the company completed the acquisition of 3-Dimensional Pharmaceuticals, Inc., a company with a technology platform focused on the discovery and development of potential new drugs in early stage development for the treatment of cardiovascular disorders, oncology and inflammation. During the same quarter, the company also completed the acquisition of Orquest, Inc., a privately held biotechnology company focused on developing biological implants for orthopaedics and spine surgery. Orquest's principal product, Healos Bone Graft Material, is designed to reduce the time and pain associated with standard bone graft harvesting and represents a therapeutic advance for patients requiring bone graft material for spine fusion or other surgery.

Behind the unhindered growth of the company is also a proficient management and a culture which breed independence. The company's business units spread across the globe have been given total autonomy in terms of setting their own business strategies, have their own finance and human resources departments. This helped independent units get away with the ills of bureaucracy, which comes in the wake of creativity. Experts opine that the company has been able to turn itself into a drug giant because it gives near-total autonomy to all its businesses, even acquired ones. That kind of a freedom has helped the company foster an entrepreneurial attitude that has kept it stay competitive while the competition has been faltering.

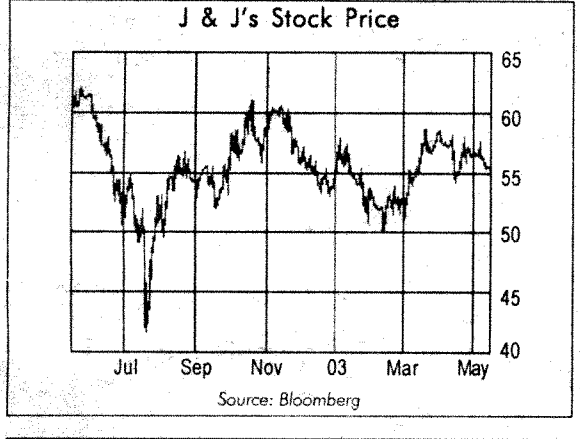
J&J's Financials – A Healthy Growth

(Figures in $ mn)

	2002	2001	2000	1999	1998	1997
Sales	36,298	32,317	29,172	27,357	23,811	22,522
Cost of products sold	10,447	9,581	8,957	8,539	7,700	7,350
Selling, marketing and administrative expenses	12,216	11,260	10,495	10,065	8,525	8,185
Research expense	3,957	3,591	3,105	2,768	2,506	2,373
Interest income	-256	-456	-429	-266	-302	-263
Earnings before provision for taxes on income	9,291	7,898	6,868	5,877	4,333	4,342
Provision for taxes on income	2,694	2,230	1,915	1,604	1,232	1,237
Earnings before cumulative effect of accounting changes	6,597	5,668	4,953	4,273	3,101	3,105
Net earnings	6,597	5,668	4,953	4,273	3,101	3,105

A challenging future

So far the company has been able to achieve constant growth that has been the envy of its competitors. However, industry analysts maintain that sustaining such a healthy growth would not be easier for the company, going ahead. For, just to keep going, the company would have to create a new $4 bn business every year, something that looks difficult, if not impossible, given the increasing competition in some of the important drug categories. The impact of this was visible when the company admitted recently that during the first quarter of 2003, Procrit was impacted by increased competition and had minimal reported growth. Growth of the company's biggest selling drug has been facing strong competition from Aranesp, a drug from the rival company Amgen. Analysts even say that sales from Procrit, which grew at a 20% plus rate over the past few years, could fall as much as 90% globally in 2003. The company is facing further competition at its $1.3 bn rheumatoid arthritis drug Remicade from Amgen and Abbott Laboratories. However, the company at the moment is trying to downplay the threat with backing from its strong drug pipeline; it claims to have 56 drugs in late-stage testing.



To deal with rising competition the company may continue with its time-tested strategy of growth through acquisition, however, even there the company could see increased competition. The fact is that many of the big players in the drug industry today are under pressure to deliver blockbuster drugs as the patents on many of the blockbuster drugs from yesteryears are expiring. This could have significant impact on the bottom lines of these drug majors. With the R&D costs flaring up and pace of scientific developments increasing, making obsoleteness a permanent threat, companies can ill afford to waste their efforts. Further, finding a best fit would also be not that easy.

Another concern the drug major will have to deal with relates to the autonomy of its cluster of businesses globally. So far, the company's subsidiaries operated as independent units. However, in the changing scenario, when convergence (between three basic areas such as drugs, devices, and diagnostics) is increasingly becoming crucial, the company can ill afford to allow its units function in isolation. Only time can say whether the company is going to buckle down under its own size or give in to competition. Dealing with these challenges would be the key to future growth.

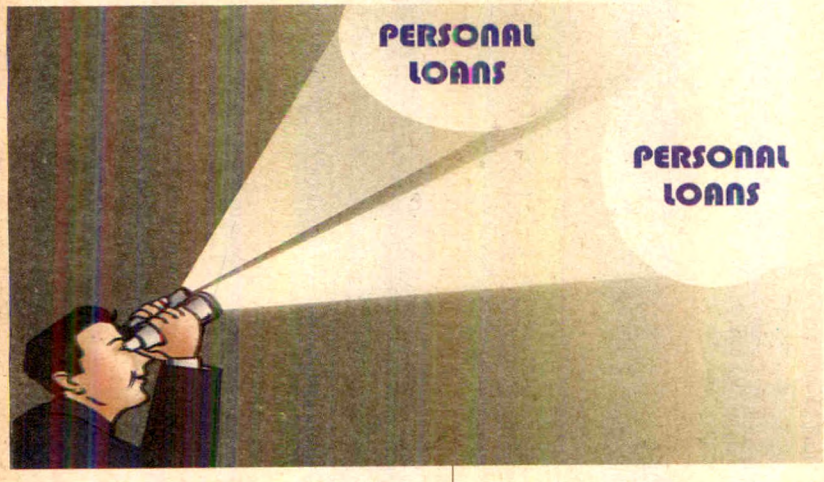
Amit Singh Sisodiya

Reference # 1-2003-06-12

INDIAN BANKS

The retail shift

Considering the present economic condition, the performance of Indian banks has been impressive. However, one significant aspect is the banks increasing emphasis on retail segment. Is the change in focus justified?



Opening up of the economy, globalization, privatization, deregulation, and liberalization have virtually led to creation of a global village wherein banking companies, for their survival, need to focus on cost, speed and quality of service to face intense competition and enormous challenges. Banks today operate under thin spreads, declining margins and rising costs. Consumer finance was not a favored subject for banks until now. They were keen to finance production-based activities. However, with slowdown, industrial sickness and failure of industrial giants of yesteryears, banks prefer to be selective in their lending operations as lending to corporate houses today appears to be risky in view of uncertainty in the economic environment and as a result of changing demographics in the country, banks diverted their resources to retail lending. It would also be noteworthy to mention that the impressive bottom line in most of the banks is reflected due to their treasury operations.

The performance of banks in the present economic conditions has raised several eyebrows. Some of the issues that are debatable are: Is there a shift of focus in the banking arena from financing working capital and term loan requirements of the corporate to retail lending? What is the source of earnings that is going to dominate the income statement of banks in the FY 2002-03 and FY 2003-04? Whether an excessive dependence on investments income and an aggressive search for fee-based income to boost earnings is critical for banks? Are banks trying to reduce their risks by diversifying portfolio and having a thrust on short-term retail earnings rather than blocking funds in riskier medium and long-term loans? What will be the long-term implications of the changing scenario in the banking sector?

Emphasizing on retail

Banks look up to retail lending as a possible avenue to augment business in the current context. Hence, all public sector banks, new and old private sector banks as well as foreign banks focus on personal banking. Retail lending appears to be a viable alternative to cope with poor credit off takes. NPA as a percentage of advances remain at a substantial level, despite hard efforts by banks to bring them down. Furthermore, the percentage of NPA is also more in advances to traditional sectors—like industry, commerce, and project financing. With progressive reduction of reserves (SLR/CRR), banks experience abundant liquidity. The treasury department of the banks are also making their impact on the bottom line. Treasury manager is also keen on investing in the stock markets apart from gilts to get better returns with the application of his professional knowledge and skills.

Now, the question is, where is the banking industry heading to? In the changed scenario, it still remains obscure that which prospect is the most promising one and as a constant and viable source of revenue and profitability for banks in future. What does it indicate if DFIs such as ICICI and IDBI intend to merge with their commercial banking arms and the banks are making an attempt to tie-up with insurance companies and other concentric sources to diversify their portfolio with an obvious step towards becoming a one-stop shop for providing all sorts of financial services under one umbrella.

It is time now to reason out the cause of the revolution in the banking industry. The rise of consumerism in the late 1980s and early 1990s gave a lot of fillip for banks to take up retail banking in a big way. Retail lending has almost doubled in the last three years. For the banking system, between December 2001 and March 2002,

50% of incremental credit growth came from retail sector. The size of the retail market is of the order of Rs. 50,000 cr (which is inclusive of credit card spending of Rs. 10,000 cr). The markets for rest of the sectors are: White goods at Rs. 4,000 cr (with a compounded annual growth rate of 10%), Auto loans at Rs. 7,500 cr (5% CAGR), Home loans at Rs. 25,000 cr (30% CAGR), Personal loans at Rs. 4,000 cr (10-15% CAGR).

Further, economic growth is fueled by increased level of consumer spending. Banks have taken to retail lending route due to failures in other sectors of financing which has dragged the NPA levels to more than Rs. 1,00,000 cr. Banks have adapted to retail banking in view of the huge potential. Some of the statistical data will provide the rationale for banks taking up to retail lending. Market penetration is just 2% of GDP in India as against 20% in South-East Asia and 50% in US. The contribution of services sector is at 52% of GDP in our country and the change in composition of rural population is from 85% in 1950 to 65% today. Out of every 100 ventures set up in India 56 are in consumer-oriented business. Only 20 crore people have bank accounts in a country of 100 crore population. There is a shortage of dwelling houses in the country to the extent of nearly 19 million. Consumer credit is just 3% of total credit in India as against 70% in other countries. There is a low delinquency rate in respect of loans to retail sector. Middle class is expected to reach 500 million levels by 2005 that seems to be more willing to spend for equipment, clothes, vehicles, mobile phones, acquisition of house etc., which were considered as luxuries in the past. Both husband and wife are earning leading to a double income concept resulting in enough disposable income with the middle class. Moreover, people's mindset is shifting to go for loans to equip themselves, as advertisements and sales promotion campaigns make them break all traditional values; instead of save and buy, they buy and save with an endeavor to lead a comfortable life.

Why is retail attractive?

From the banks' perspective, growth of retail sector is the prescription of lower margins as it offers immense scope for improving their credit portfolios in the absence of demand of corporate loans which are further more risky due to increasing NPA levels in the same. Banks are inclined to do business in volumes, to manage their spreads and improve the bottom line, and thus, are tying-up with manufacturers, builders, vehicle suppliers to facilitate quicker release of loans. Naturally, in the current context, IT influence will be profound in respect of all areas of retail banking; technology becomes an important tool—an enabler for all services, viz., Net banking, Mobile banking, Tele-banking, Demat accounts and ATM. There is an intense competition among all categories of banks to knock-off the lion's share.

In the current context, IT influence will be profound in respect of all areas of retail banking; technology becomes an important tool—an enabler for all services

Thus, the scenario is becoming highly competitive in every sphere of banking activity and more so in respect of retail lending. Initially, credit card culture was pioneered by foreign banks like Citibank and Standard Chartered in our country. Credit cards in India are used more as a transactional investment rather than as a medium of servicing credit. There are six million cards in use against the potential that is estimated at 40 million. The credit cards have increased from Rs. 5 lakh in 1992 to Rs. 60 lakh by 2002 at an average growth of 20% per annum. The average annual spending through credit cards is around Rs. 18,000 cr which is less than 1% of total personal consumption spending in India, as compared to 30% in US. It offers an attractive interest of 30 to 36%. Credit card usage also entitles holders for attractive bonus, incentives and loyalty points. Along with credit cards, the debit cards usage is also becoming popular with a card base of 1 million.

Consumer credit encompasses extension of loans for white goods, education loans, finance for travel, medical expenses etc. Demand for loans for acquisition of TV, cellular phones, air-conditioners, dishwasher, washing machines, refridgerator etc., is on the rise. Banks also offer loans through tie-ups with corporates. There are nearly 12 lakh retail outlets contributing to Rs. 14,000 cr to the GDP (i.e., about 1.2% of GDP). Further investment of Rs. 35,000 cr is in the pipeline. With envisaged increase in GDP growth, increased income levels and changing lifestyles, there is good potential under the auto finance segment. The market size is Rs. 7,500 cr that is next only to housing finance segment. ICICI Bank funds 15% of cars that are rolled out. The factors that propel the growth of auto finance are low interest rates, poor urban transport in many areas, increasing income levels, and availability of finance for even second-hand cars. Nearly 3 lakh second-hand cars have been financed which also provide a boost to the auto manufacturing sector. In fact on account of liberal financing by banks, production of passenger cars, motor cycles and scooters, has registered good growth.

Housing finance is one area which seems to be most promising in the near future due to fall in interest rates, increased start-up salaries, aspirational changes in lifestyle, offer of free insurance cover for various risks, offer of various incentives in the form of

"Retail is a growth area offering immense opportunities and potential for credit expansion by banks"

K V Krishnamurthy, Chairman and Managing Director, Bank of India.

O On shift of focus.

It is not a question of shift of focus but harnessing the emerging opportunities. Retail is a growth area offering immense opportunities and potential for credit expansion by banks in view of better returns offered by this segment and comparatively lesser asset quality problems i.e., low NPA level in this sector. Moreover, this helps the banks in diversifying their credit risk. Not only this, the retail segment is important even from the viewpoint of low cost resource mobilization by banks.

Nevertheless, corporate lending, both working capital and term loan, being the core activity, continues to be in focus with the banks for bulk lendings depending on the overall economic environment and requirements of the sector, as well as to earn substantial fee income from them.

Though the trend of late, with the prime corporate borrowers have been to bargain for low and sub-PLR interest rates, the sector offers immediate channel for deployment of short-term surpluses of banks and to earn good and quick income in the process. However, the demand for working capital from the corporates in the recent past have been low and because of the project implementations getting delayed, credit off take by the corporates have been low. Moreover, with better supply chain management and operational efficiency of the corporates, the optimum utilization of working capital by them has been ensured. However, with the manufacturing sector now gaining momentum, the credit deployment to corporates should now accelerate.

O On investments income vs. fee-based income.

lower processing and administrative charges, interest on reducing balance method, choice or option for fixed/floating interest rates and last but not the least, income tax shelters on interest paid. The key players are HDFC, LICHF, Canfin Home, SBI, ICICI and Bank of Baroda. There is stiff competition in the matter of interest rates—rate cuts are announced at very frequent intervals. The market size is Rs. 25,000 cr that is expected to grow to Rs. 40,000 cr. Size of the loan varies from Rs. 2 lakh to Rs. 1 cr. Average tenure of housing loans is 15 years. Lower default rate of 0.5% is a big attraction for banks to take-up housing finance. It provides a big impetus for housing construction activities also leading to growth in infrastructure industry.

The average annual spending through credit cards is around Rs. 18,000 cr which is less than 1% of total personal consumption spending in India

Setting a new trend

The future of banking is dependent on technology, marketing, and logistics. Technological breakthrough facilitates reduction in transaction cost as well as ability to do business in volumes. Banks have to prepare themselves to face a soft interest regime. New kinds of management skills are required to manage the retail-lending portfolio, otherwise it won't take time for Indian banks like ICICI Bank to get on the path of erstwhile Citibank, now E-serve, that is considered to be the leading issuer of credit cards in the world. Low-income debtors frequently obtain credit that they are unable to repay because the bank fails to ensure that its minimum credit standards are applied by the branch personnel. Consequently, Citibank was New York's largest plaintiff, within a two-year period, Citibank filed over 25,000 lawsuits to recover money from debtors in default. Default risk can be higher in retail lending if proper care is not taken in credit disbursements and can increase further as far as different facets of retail lending are concerned. It is at present highest in the consumer credit at the levels of 3-4%. Thus, bankers need to realize that not every man or woman can mean business to the bank and it should be profitability and not just the growth that should remain the hallmark of the banking operations.

Banks are flush with funds. It is what a bank actually does with those assets that demonstrate the real stature of the organization and determine the true role it will play within the industry and throughout the business world. Given this, an aggressive search for non-fund-based income is critical for most of the banks. Over the last couple of years, profit on sale of investments mostly comprising of government securities, which have seen a sharp rally in recent times due to decline in interest rates, has dominated the income from other sources of banks which is understandable as such gains were responsible for the 50% increase in the profit of the banking sector in the FY 2002. However, an excessive dependence on investments to boost earnings, as it is presently happening with most of the banks such as Bank of India,

The net interest margins of the banks are under pressure increasingly in the falling interest rate scenario and competitive pressures of sub-PLR lendings. The problems in the operating environment resulting in sluggish credit off take at times, complexities of the credit risk, the asset quality problems resulting in burgeoning NPAs and the enhancing capital adequacy norms, are forcing banks to look for enhanced share of fee-based income by diversifying income streams like, distribution of Insurance and Mutual Fund Products, Retailing of G-Secs, issuing of Credit/ Debit Cards, Cash Management Services etc. The volatility in the interest rate scenario has also offered scope to banks to maximize their earnings on their investment portfolio. Investments continue to be a preferred channel for deployment of resources by banks in the continuing soft interest rate regime to enhance earnings. The trend may continue in the near term, though to a lesser extent.

O On the impact on income statements of banks (FY 2002-03 and FY 2003-04).

The income statement of the banks will show declining spreads, a boost in non-interest income mainly contributed by treasury income and reduced operating expenses due to operating cost-cutting measures adopted by most of the banks like VRS, reduction in transaction cost through technology initiatives etc.

O On portfolio diversification.

The portfolio diversification is more with a view to improve the yields on lendings and containing the NPAs as well as from the risk management perception by spreading the risk. The medium and long-term lendings is more related to asset-liability management aspect. This also depends on sound and viable projects and timely project implementation.

O On long-term implications of the changing scenario.

The long-term implications on the banking sector is that the banks are becoming financial supermarkets offering all sorts of financial products and services and in the process expanding their base and areas for profit maximization through better risk management.

SBI, Bank of Baroda, PNB, HDFC Bank and Canara Bank in which case other income to net profit ratio is greater than one for the quarter ended December 2002, may not be a good idea, as the low interest regime could turn on its head anytime. Banks are now required to create an Investment Fluctuation Reserve (IFR) from the gains realized on the sale of investments in securities arising out of decline in interest rates. Over a five-year period, banks have to target a minimum IFR of 5% of all investments in 'held for trading' and 'available for sale' categories. This reserve is expected to provide a cushion against depreciation in the value of investments if the interest rates firm up. However, even the best placed Punjab National Bank has an IFR of only 1.1% of the total investments of Rs. 28,207 cr and the mammoth SBI group of banks had an outstanding balance of Rs. 1,228.61 cr in its IFR which is only 0.66% of the Rs. 1,85,587.29 cr investment of the group. It is needless to mention that only those banks that have a substantial portion of their other income comprising of fee and commission would be unaffected in a rising interest rate scenario but rest would really find it difficult to cope with the situation if adequate provision for portfolio depreciation is not made.

Bankers need to realize that not every man or woman can mean business to the bank and it should be profitability that should remain the hallmark of the banking operations

What is noteworthy is that but for a higher other income reflected mostly due to their treasury operations, the bottom line of most of the banks would be mediocre in the FY 2002-03 and FY 2003-04. The future is always uncertain but in the present scenario of declining trends in working capital finances by the banks, retail lending is the only viable alternative for the banking industry to survive.

Thus, it is not denying the fact that the idea of 'Universal Banking' has promulgated new initiatives and innovations, new strategies, new products, new delivery mechanisms, ability to cross-sell products, consumer orientation in everything that a bank does, focusing on relationship management. Banks are also on the lookout towards diversification of business to profitable channels where delinquency rate is low, developing proper risk forecasting techniques, improving organizational effectiveness, imaginative corporate planning and implicit execution. Universal banking has also brought in new initiatives like organizational restructuring, technology initiatives turning out the brick and mortar structure of the banks to the Net-savvy mouse-click banking, customer care, aggressive marketing strategies, positioning products as a brand, reorient, redesign, reengineer and reinvent work processes besides every employee exhibiting entrepreneurial spirit and working with more professionalism as a prerequisite for ensuring optimal size and soundness of banks in future.

Kunal Tela

Reference # 1-2003-06-13

SUSTAINING IN DOWNTURN

Against the odds

Remaining profitable in adverse economic conditions is an acid test for companies. Companies like Siemens of Germany and Takeda Chemicals of Japan, to name a few, have flourished in the slowed down economies of Germany and Japan. What are the recipes of their success?

Economic slowdowns and recessions are part of business cycles which companies have to live with. Slowdowns and recessions put a break on growth and sales and have a downward effect on prices. While many companies face their demise as they fail to pull themselves out of the economic quagmire, some emerge stronger than they were prior to the slowdown or recession hit the economy.

Some companies have withered the ongoing deflationary economic condition in Japan and in slowed down Germany and emerged winners by making strategic choices that sometimes defy conventional wisdom. Companies like Kao and Nissan in Japan, Siemens and Lufthansa in Germany to name a few have performed extremely well by following conventional approaches as well as by unconventional ones.

Good management

Good management has always been vital for survival of companies irrespective of whether good or bad business conditions. However, good management is put to an acid test during the time of adversity. How CEOs provide leadership and navigate the company during adverse business conditions becomes the central point. James Calvin, Associate Professor, Department of Management and Director, Leadership Development Program, School of Professional Studies in Business and Education, John Hopkins University, also agrees. He says, "I view the role of CEO as central to the enterprise (during adverse times)."

Siemens, one of the world's largest engineering companies based in Germany, has survived with relative ease during slow growth times in Germany because of its CEO Heinrich von Pierer's business practices. He changed Siemens notorious bureaucratic culture into a fast decision-making company, where divisional and regional managers are given the power to take decision. However, the corporate office closely monitors the signing of contracts and the execution of projects. Heinrich von Pierer also put into place strong risk management program which emphasized on 'economic value added' for investing in any project and an internal accounting system based on GAAP. It also refrained from offering vendor financing and generous contract guarantees to its customers, especially in the 3G-telecom sector, to win customers and business.

Another company, which benefitted immensely from good management, is Canon of Japan. Under Fujio Mitarai's leadership, Canon has remained profitable over the years. Canon's success is more eye-catching because so many other Japanese high-tech companies like Hitachi, Matsushita, and others have all posted losses in Japan's deflationary economic condition. The company did not even shift its manufacturing plants to low-cost China when most of the global companies are doing so.

CEO of Canon, Fujio Mitarai, has followed a hybrid management style in running Canon. On one hand, he followed the business practices of American companies, such as quick decision-making, incentives for managers based on performance and not on seniority, giving importance to profitability and not market share, and projecting his personality throughout the company. While on the other hand, he gives importance to traditional Japanese business values of providing lifetime employment, and forming quality circles, where workers are encouraged to come up with their own solutions to problems. The result, Canon has been successful to increase its share in the high-end market of enterprise-wide document and

imaging, a territory dominated by Xerox.

However, Professor Calvin also says, "There are no universal expectations of CEOs in many organizations beyond the role of vision and performance and all that goes into linking vision to practice to performance. In the US at this time there is a major national debate on what is expected of the CEO given the severity of ethical considerations and decisions that are being made or not during this period of expanding globalization. In some other regions of the world, the role of CEO might not be the same but it might have some similar aspects and elements."

Cost-cutting

The most common measure that managers take at the first sign of slowed down economy or recession is to cut costs, which include retrenchment of employees, reduction in capital expenditures and R&D budget, marketing and investments in technology. Companies also drop services, which the competitors do not offer, and force suppliers to cut costs. However, all these measures are short-term.

Cost-cutting is important, but it needs to be executed carefully. Instead of across the board cost-cutting, companies need to categorize costs as either value-added (R&D, marketing etc.) or non-value-added costs (administrative functions etc.), and aim to reduce non-value-added costs. Companies also need to convert as much as possible of their fixed costs to variable costs, because reduction in variable costs do not affect much of the bottom line of the companies. For example, outsourcing of those back-office operations that do not support present or future revenue growth but relate to non-value-added functions. Lufthansa, the German airlines, had generated more than $890 mn in cash flow in 2002, higher than that of profitable discounter Southwest Airlines by judicious cost-cutting, which included reduction in capacity on short and medium haul routes where demand is weak and outsourcing part of its business.

Another important aspect of cost-cutting is that consistency need to be maintained in cost management. A company should not act in one way during good business conditions and in another way during bad business conditions. Otherwise, employees, suppliers, and other business partners would lose confidence in the company, which would have a negative effect on morale, cooperation and productivity. For more than a decade, Lufthansa has maintained its quality of service and flexibility of routes both in good times and bad times (like during the Asian crises in the late 1990s).

A company should not act one way in good business conditions and in another way in bad business conditions

Investing in R&D

As mentioned earlier, reducing investment in R&D is not the right strategy for cost-cutting. Rather, companies need to do the opposite; spend heavily on R&D. Most of the successful companies in Japan and Germany have spent heavily in R&D for product development. Kao, a Japanese consumer goods manufacturer has introduced a special low-fat cooking oil in 1999, called Econa, priced thrice that of the normal cooking oils, and experienced a double-digit sales growth in Japan since its launch. To stay ahead in competition, Canon has increased its R&D spending from 6% to 8% of sales. Sony is investing heavily in R&D to develop a new type of microchip to power its PlayStation video game console and a range of electronic devices such as wireless handheld computers. Infineon, Siemens spun-off company engaged in designing and manufacturing high-value chips invests heavily in R&D, $940 mn in 2002, and also employs 5,400 people in R&D out of total staff of 30,000.

Sticking to the core

Companies pursue a policy of diversification at good times, only to divest some of its diversified business during bad times. Vivendi of France, a utility company, which had expanded and diversified in media, during the time of Internet boom had to divest much of its assets when growth in the European and American economy slowed. Another example is ABB, an engineering conglomerate from Europe, which is also divesting many of its diversified businesses in order to stay alive. These companies have diversified by taking huge debts during the period of growth and once the growth slowed or stopped the liability of high debt servicing affected their free cash flows, and as a result restricted their 'strategic maneuverability'.

Another negative aspect of reckless diversification is that it stretches the already tight resources too much which severely affects the company's bottom line during adverse times. Under Jacques Nasser, Ford acquired Kwik-Fit car repair chain, a scrap-yard business in the US and consumer finance arm of Mazda to turn Ford into a consumer product and service-related company from a car manufacturer. But Ford's sales slipped as it faced problems in product planning, quality control and capacity utilization. Within a span of three years, Ford racked up losses, which ran into billions.

On the other hand, successful companies like NEC, a Japanese industrial-electronics group had spun off its money-losing memory-chip business and closed down its old plants. It also merged its profitable unit, making chips for

cars and the electronics industry into a new company, which would be better positioned to respond rapidly to semiconductor-industry fluctuations. The plan would let NEC concentrate on more profitable business, such as developing new cellphones and building computer systems for corporate clients.

In Germany too, to remain profitable, Lufthansa in 2002 had divested its stake in DHL World Wide Express to Deutsche Post World Net and sold off its poor performing Start Amadeus travel sales system. It had also successfully trimmed its broad portfolio of business by spinning off some of its businesses into independent companies. To focus only on its core business of flying long-haul flights, it had created a 100%-owned subsidiary called CityLine for shorter hauls.

For Siemens, China has become its third largest market with sales of around $3.5 bn

Some companies have also trimmed product portfolios, focusing only on products or brands where they could establish a clear lead. In 2001, Shiseido, Japan's largest cosmetic group, to turn profitable, streamlined its product portfolio. Canon has refocused itself on four main product lines, copiers, printers, digital cameras, and chip-making equipment.

Going global

According to Professor Calvin, "Globalization holds a great deal of appeal for business organizations for accessing markets and expanding product opportunities." Companies who are successful in beating the deflationary economic conditions have gone global. Canon derives 70% of its revenues from outside Japan. Takeda Chemicals, Japan's largest pharmaceutical company, which has been profitable for the last 10 years generates much of its revenues from overseas markets. The company has entered into marketing alliances with Eli Lilly and established a strong sales network in America, the world's largest pharmaceutical market.

Toyota and Honda, the top two Japanese automobile companies, derive large percentage of their profits from America. In the recently released first quarter results, the US sales of both Honda and Toyota have increased compared to that of Japan sales. Nissan, the third big auto company of Japan took the global route under Carlos Ghosn, after Renault bought a stake in Nissan in 1999. The increased global thrust has been cited as one of the reasons for Nissan's quick turnaround. Carlos Ghosn also built a new plant at Canton, Mississippi, US where Nissan's new full size truck and several other models would be manufactured. Lufthansa earns nearly 40% of its total traffic revenues from outside Europe. German automobile manufacturer, DaimlerChrysler has entered China, an emerging market, to increase sales. For Siemens also, China has become its third largest market with sales of around $3.5 bn.

Acquiring cheap assets

With limited cash, unavailability of debt and depressed stock price being the characteristics of downturn, most believe that acquisitions are too risky during a downturn. However, downturns also provide opportunities for companies to acquire cheap asset; both tangible and intangible. Companies should assess their current capabilities in light of future goals and search for ways to fill the gaps through acquisitions. Companies that have made the right acquisitions during the downturn are better positioned to outperform competitors once the economy improves. Daimler-Benz acquired an American company Chrysler. The acquisition helped Daimler-Benz to gain economies of scale and greater access to American market. Knorr-Bremse, a German manufacturing company producing braking systems for trains and lorries, has made around 28 acquisitions since 1985 and its largest acquisition was made in early 2002, which made it the market leader in lorry brakes market in America. Knorr-Bremse now has a 40% share of the world market for braking systems used in trains and lorries. Siemens had spent about $9 bn in the past six years to acquire assets like power line, power generation and fuel cell divisions of Westinghouse. Canon is looking for an acquisition of software and services company in the US that would enable Canon to manage documents and images across the Internet and other platforms.

Improving processes

Good business processes help companies to emerge winners in downturns. The best Japanese companies like Toyota, Honda and Canon are world beaters at logistics. Toyota Production System has become the epitome of efficient manufacturing process. Honda has a network of factories around the world, all connected into the supply chain. The company has installed a new manufacturing system, called 'Ultimate Flex', which helps Honda to build every car in Honda's stable in each of its manufacturing plant. It also keeps production-line changes simple as new tools and jigs could be installed faster with the mere touch of a button. 'Ultimate Flex' makes Honda to efficiently balance supply and demand of cars without excess inventory and helps Honda to adjust its manufacturing quickly to manufacture a new car.

To get more productivity out of its Japanese workforce, Canon has replaced its traditional assembly lines with 'cell' production. 'Cell' consists of small teams of six

workers, which builds the whole of a copying machine. Production equipment has also been made lighter and more modular than before, which could be easily reconfigured. Seven-Eleven, the largest convenience-store chain in Japan, has a custom-built information system that complies extensive sales data. The system helped the company to improve quality control and assisted in pricing, product development and inventory management. Shiseido, after installing a new computer network linking factories, sales staff, and 16,000 stores, has been able to forecast demand more accurately. As a result, the company has been able to slash inventory by a third from its earlier time.

Listening to customers

Economic slowdowns hit everyone, including customers, partners and other stakeholders of a company. Successful companies have used downturn to their advantage by working closely with all the stakeholders of the company. Many have build close relationship with customers, by paying attention to what the customers say. Knorr-Bremse came to a conclusion, after listening to its customers, that it was not good enough for the company to manufacture only braking components. It had to develop complete systems, which would offer its customers more value.

The frequent excuse of recession by companies for their failure to grow no longer holds

Siemens also had to adapt itself to the changing needs of its customers. For example, earlier its transport division used to manufacture only electrical systems for trains. However, the changing needs of its customers compelled Siemens to broaden its operations to start manufacturing locomotives and carriages and change itself to become 'system provider', to offer complete locomotives and trains. Similarly, its medical equipment division has been restructured for customer focus from its earlier focus on functions.

Conclusion

To avoid untimely death in tough business conditions, companies, need to follow approaches as followed by some of the successful Japanese and German companies, instead of just curtailing investment, taking across-the-board cost-cutting measures and reducing prices, some of which bring only short-term benefits. Professor Calvin views, "The success of some German and Japanese companies is that they have well defined strategies for engaging in business and that they have solid market niches and partnerships in place. Also I think, that there are other important factors such as quality branding and best in class recognition."

They could also learn from the experience of other companies in other industries. For example, Ford of USA. Ford has been using computer modeling and US surveys to boost revenues for each sale of its automobiles against across-the-board rebate and 0% financing offered by its rival GM. Ford in alliance with J D Power & Associates has established a database of sales transactions from 2,700 dealerships in the US, which includes prices, incentives, financing costs and trade-in values. Computers then calculate how a change in a vehicle's price, incentives or features would affect sales volume. The computer models also guide Ford in keeping incentives at a level at which sales would not outstrip factory capacity. The yield management successfully put in place by Ford has its roots in hotels and airlines and not in any manufacturing company.

> **"A recession promotes opportunities for companies that are well positioned to take advantage of the opportunities that are advanced by a recession."**
>
> **James Calvin**
> *Associate Professor*
> *Department of Management and Director*
> *Leadership Development Program*
> *School of Professional Studies in Business and Education*
> *John Hopkins University*

For many firms, the downturn is not a threat, rather a great opportunity to march ahead of its competitors. Professor Calvin says, "A recession promotes opportunities for companies that are well positioned to take advantage of the opportunities that are advanced by a recession. For example, an organization that has not drifted from its core or primary focus can take advantage of an equilibrium factor (the principle of force-field analysis)."

The success of the companies mentioned above proves that the frequent excuse of recession by companies for their failure to grow no longer holds. Rather, as Professor Calvin opines, "I see growth in companies as both natural and planned business process that is contingent on many factors and one such condition is a recession. Briefly, the issue expands in scope to sustainable growth that involves markets, product(s) and quality that help to set and maintain prices and sales."

Anindya Roy

Reference # 1-2003-06-15

FIAT AUTO

Time for overhaul

Fiat Auto is in deep trouble. With mounting losses and increasing debt burden, the automaker is proving to be a burden on the group companies and is forcing the management to think about selling the auto business. Can Fiat Auto steer out of this mess?

Fiat Auto, part of Fiat group (Fiat), one of the biggest industrial houses of Italy and an icon of the Italian industry was going through one of the bleakest periods in its 103-year history. From 1997 to 2001 the company lost around $2.5 bn, of which $1.3 bn was incurred in 2001. At the beginning of 1990s Fiat Auto held on to a 14% of the European market; by 2000 it was slipping into single figures. The company was also losing ground in Italy with a share of less than 27.6% of Italian car sales as of March 2003, sliding from 44% in 1992.

The gaps in the product lines combined with the failure of new vehicles that were expected to boost profits, the falling production and quality left the company's finances in bad shape. The automaker was operating at 75% of the capacity compared to the industry average of 80% that was considered to be essential for any automaker to make money. The company that was once a major contributor to the revenues of the group was sliding towards decline and was bringing down the group with it. At the same time, the other businesses of the group were not able to produce enough profit to plug the hole.

In May 2002, Fiat agreed to a radical restructuring of Fiat Auto in return for a $3 bn loan. But the sweeping restructuring initiative including the closure of 18 plants and 6,000 jobs outside Italy did not show much result. The loss in 2002 was estimated to be of $1.46 bn at the operating level. In addition, the changes led to strikes and protests, giving a political dimension to the crisis. Italy's Prime Minister Silvio Berlusconi intervened to provide what was considered to be an 'Italian' solution to the problem. Consequently, the government put forward the idea of 'ItalAuto', a state-owned carmaker that would save Fiat Auto. While the creditor banks believed in a market-driven rescue of Fiat, the government, under electoral pressure, wanted more direct action.

One possible solution was to sell the Auto business. But Gianni Agnelli, the then 81 year-old honorary chairman of the group opposed the idea of selling the company that was a symbol of their family pride. But the continual poor performance of the car businesses undermined hopes of recovery and led to speculation that Fiat Auto would be sold. The death of Gianni in January 2003 was expected to hasten the break-up of the Fiat Empire. After Gianni's death, Umberto Agnelli who favored the sale of Fiat Auto in favor of keeping other businesses afloat was nominated as chairman of the group. To survive, the auto business required infusion of cash both to add new models and at the same time stop the losses from mounting.

Background note

In the year 1899, the Agnelli family founded Fiat, Italy's largest industrial group, in Turin. Originally a carmaker, Fiat diversified to produce tractors, trucks and airplanes. After Giovanni Agnelli who was at the helm till he died in 1945, the responsibility of running the family business fell on his grandson Gianni. After World War-II, Fiat faced the danger of being confiscated. But Gianni successfully persuaded the Americans to keep Fiat in private hands. He then brought Vittorio Valletta, a Fiat veteran to the top job. This was seen as an outcome of Gianni's unwillingness to take up big responsibility.

After a few years, Gianni finally accepted the responsibility and took over the reigns of the company in 1966. Inspired by the American automobile companies, Gianni introduced assembly line production to Fiat Auto. He also observed that the company was relying too much on the Italian market and for a short period merged with Citroën of France. As a result, Fiat Auto emerged as the world's third largest car producer after General Motors and Ford. But in the late 1960s Italy's economic problems and mounting pressure of social and industrial tensions started to show its effect on Fiat Auto's sales. Union militancy increased and Fiat Auto witnessed strikes. Production was badly affected and in 1973 the company reported a loss. All these forced Gianni to cut the dividend for the first time since 1945.

Meanwhile, Organization for Petroleum Exporting Countries (OPEC) increased oil prices and as a result Gianni began to reduce Fiat's dependence on cars. Instead he focused on public transport, choosing to make more buses and trains. By 1980s Fiat emerged as a conglomerate ranging from Telecommunications to Pharmaceuticals. This diversification was considered to be an ill-judged move given the fact that the core business of making cars was deprived of the capital it needed to consolidate its strong position.

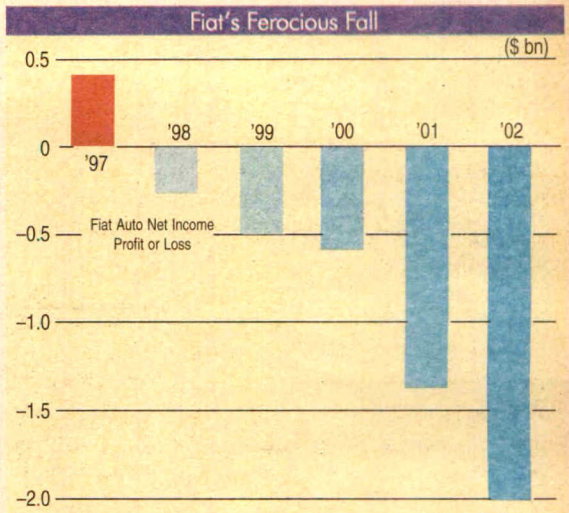
After some years of struggle, in the mid-1980s, Gianni initiated some tough measures. He began to give free hand to professional managers and also ousted his younger brother Umberto.

In 1983, Fiat Auto came up with 'Uno' considered to be one of the most efficient cars of that time. Uno provided the necessary impetus to the company and by mid-1980s, Fiat Auto began to make profits that helped it eliminate most of its debts. At that time Fiat Auto was such an attractive proposition that Ford Motors had shown interest in merging Fiat Auto into its European operation. But the deal did not materialize because of Gianni's unwillingness to cede control. Fiat Auto also missed an opportunity to emerge as a strong global competitor by throwing away opportunities to join hands with carmakers such as BMW, Volkswagen and Daimler-Benz all of which had shown interest in it. However, in 2000, Fiat Auto finally sold a 20% stake to General Motors (GM). According to the deal, Fiat Auto could exercise a put option that allowed it to sell the remaining 80% to GM.

In troubled waters

Most problems of Fiat Auto seemed to be self-inflicted. It failed to produce right models at the right time. Most of the times it depended on a single model. In 1980s it was Uno, in 1990s it was Punto and its Stilo was expected to provide impetus for the next decade. But its failure had left the company searching for a money-spinner. Also, the spending on R&D was in small proportion compared to its rivals. While Fiat Auto spent around $4.5 bn on R&D from 1995 to 2001, Renault and Mercedes spent more than twice that amount and Volkswagen spent around $20 bn.

The quality of vehicles proved out to be a major stumbling block for Fiat Auto. The company was known more for its small cars and was considered to be incapable of producing high quality big cars. The quality issue was a major cause for its failure in the American market. However, in spite of its failure in America, considered to be the largest market for cars, the company believed that it could achieve a global scale by tapping markets outside America. It increased its production to 4 million vehicles a year betting on markets in Brazil and Poland. This move backfired when the Brazilian crisis in 1998 was accompanied by a dramatic decrease in demand and in Poland the South Korean automobile companies had outdone the company. All this had increased the burden of overhead costs that drained cash out of the company. Some Fiat executives put the blame on deteriorating economic situation in new markets, such as Poland, Turkey, and Argentina where the company expanded into during the 1990s.



Source: BusinessWeek *January 3, 2003.*

Though the company began expanding into different countries, it showed too much dependence on markets in Italy and Brazil, which together accounted for 60% of cars sold. Also during the second half of 1990s, the company, under its CEO Roberto Testore who was at the helm till December 2001, lacked focus on new product development. While other manufacturers rapidly began invading its turf, especially in its traditional small-car segment Fiat Auto saw its share of the Italian market crashing down. John Lawson, auto analyst with Salomon Smith Barney in London commented in *Fortune* magazine: "They had too much Italy, too much small car, and, grafted on top of that, a failure to turnaround the product's image, which is one of the lowest in the European car industry."

Burdened with losses and as a result, by debts, the company reached an agreement with its banks in May 2002. According to that agreement, Fiat in return for a promise of $2.9 bn rights issue in 2005, had to either sell or fix its automobile business. This meant that if the auto business had to stay afloat in spite of the losses, the group had to sell other assets to manage its debt. The agreement was considered to have imposed many constraints on the company, stifling it for room to maneuver, posing the danger of the group going bust in the case of not meeting the commitment.

Meanwhile, the problems began to escalate when Fiat Auto announced plans to restructure its business. The proposed job cuts led to strikes and protests. Members of Berlusconi's governing right-wing coalition criticized the company for job cuts, more so because they affected the economically weak southern parts of the country.

Political intervention

There were reports that Berlusconi along with Mediobanca, a powerful Milanese investment bank that at one time controlled many industries in Italy, planned to push Fiat into bankruptcy forcing its banks to accept a debt-for-equity swap of the group's extensive assets combined with a long-term mediation to be conducted largely by Mediobanca

itself. Such moves only resulted in strengthening the feeling that Berlusconi was promoting his own cause in the guise of providing a state sponsored solution to save Fiat Auto from falling into the hands of GM. He wanted to acquire Fiat's *La Stampa*, a Turin daily, and a big stake in *Corriere della Sera*, Italy's most prestigious paper. Mediobanca was more interested in getting its hands on Fiat's profitable insurance company 'Toro', to compliment its stake in Generali and SAI Fondaria, two leading insurance companies.

Berlusconi's intervention in the group's affairs led to the resignation of its CEO Gabriele Galateri. Berlusconi's plan involved bringing in Erico Bondi, who was associated with Mediobanca, as chief executive of Fiat. But Berlusconi could not get away with his unwarranted intervention. Three hurdles stopped him in his way: Fiat Auto's deal with GM, the European Union competition rules and the company's banks that preferred a market friendly solution to the problem. Also, the support for market reforms that Berlusconi promised during election campaign stopped him from going overboard. Another crucial issue that Berlusconi faced was his reliance on the support of the powerful employers' association Confindustria that was committed to market reforms.

Amid such confusion, it was considered that a better solution to the problem was to allow the restructuring process to take place smoothly. The government's help was required in the form of support for downsizing the capacity. While Fiat Auto had a capacity of 2 million units it was able to sell only 1.4 million cars in 2001. The task that lay ahead for Berlusconi was to support closure of some plants and layoffs. But it was not an easy one to take up. Layoffs were considered to be political dynamites in Italy. But some considered it as an opportunity of Berlusconi to change the deep-rooted Italian malice that engulfed labor markets, affecting the smooth functioning of businesses and bring to the fore broad based labor market reforms.

Outlook

In 2002, the Fiat management brought in Giancarlo Boschetti, head of Fiat's truck division Iveco to lead the restructuring process at Fiat Auto. The new CEO who spent around four decades at Fiat announced plans to increase the spending on R&D and speed up new product development. But the major issue confronting him was to implement layoffs and close some of the plants. The unions were pressurizing the Italian Government to stop the company's plans.

Company officials estimated that layoffs and early retirements would reduce costs by $300 mn in 2003. Additional savings of $700 mn were expected to result from its partnership with GM. But Garel Rhys, Professor of Motor Industry Economics at University of Whales felt that those moves were not enough for Fiat Auto to survive on its own. He once told *Fortune* Magazine, "Eventually Fiat cannot stay on its own. That has nothing to do with Fiat but with the economies of carmaking." That is where GM was considered to play an important role in reviving the fortunes of Fiat Auto. Together, the two companies would be the largest automaker in Europe, with an 18% market share. Besides joint purchasing, GM and Fiat plan to cut costs through sharing platforms. Fiat Auto expects that by 2005, GM's Opel Corsa would share 70% of its parts and costs with Fiat Punto. Fiat also expects GM to sell Alfa Romeos (which were withdrawn from US market in 1995) through its dealer network from 2007.

But it was not an easy task for Fiat Auto to revive its fortunes. Analysts were growing more and more skeptical about Fiat Auto's prospects. A solid turnaround was not considered to be possible without new models. Sales of Stilo Compact, introduced in 2001, remained disappointing. Meanwhile, rivals such as Toyota had gained market share with its new cars like the Yaris in the small-car category that Fiat once owned. A turnaround also meant three to four years of heavy investment and visionary management. The cash requirements were to the tune of withstanding a cash-burn rate of $2 bn a year plus an investment of $2.5 bn a year.

Though the company was hoping to revive the lost sales through new models like the Gingo mini and the Idea minivan, to be launched in 2003, the possibility of major gains remained to be low considering the industry downturn and fierce global competition. "The margins in small cars are in terminal decline, and now you've got the Japanese and the Koreans, who can make profits at price points Fiat can only dream of," commented Stephan B Cheetham, an analyst at Sanford C Bernstein & Co. in London in *BusinessWeek*.

If Fiat Auto failed to survive as an independent carmaker, it would not only highlight company's mismanagement but also the country's flawed industrial policy that stifled competition and built inefficiencies into its businesses. Italy kept quotas on Japanese cars even after other European countries had done away with them. The government was overly protective and bailed out Fiat Auto on previous occasions by feeding it with subsidies and other concessions. As, one Italian entrepreneur commented in the *BusinessWeek* "The terrible story of Fiat reflects the protectionism, ineffectiveness, corruption, and compromise typical of the way Italy has done business for the past 30 years."

Phani Madhav

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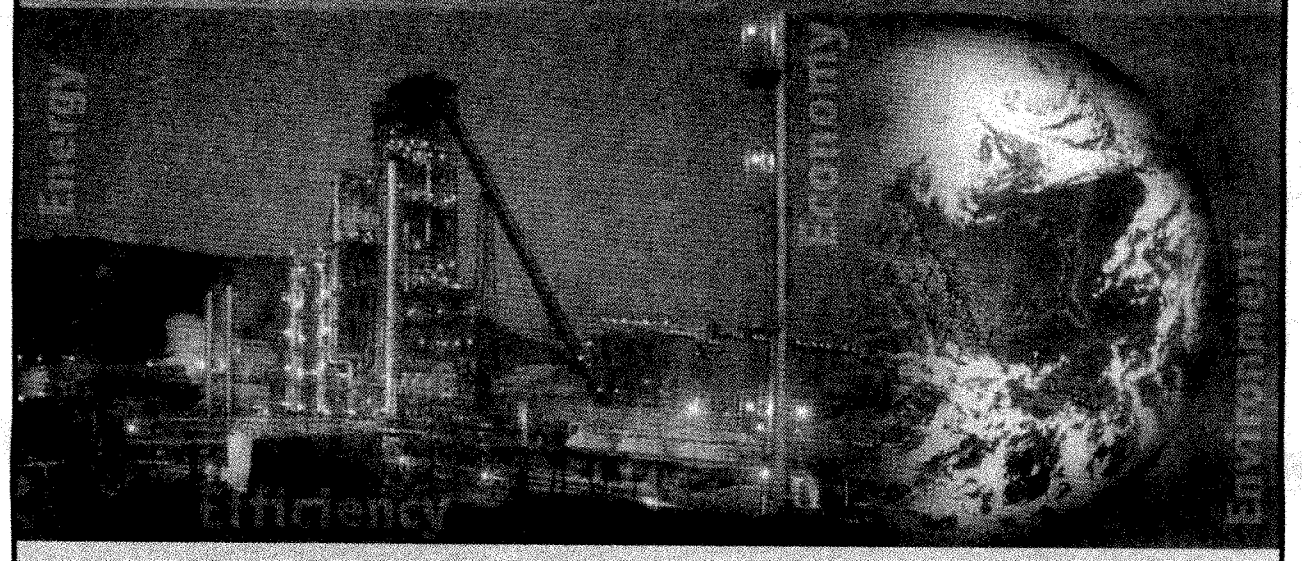

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IMAGEADS

Strategies for Successful Investing

Successful investing calls not just for a disciplined approach but it goes much beyond that. To become successful, an investor needs to demonstrate qualities such as moderation, common sense, restraint, modesty and integrity.

In the prevailing uncertain financial world, investors are desperately looking forward for certainty. They are looking for rigorous, practical, straightforward, tried-and-true advice that can be applied in both bear and bull markets. Stocks are more volatile now than ever. Even with all their potential for meteoric success, high-tech investments are synonymous with high risk. What are the strategies that investors might use to build and keep wealth, no matter which way the economic winds blow? The best qualities for investors are the ones which Aristotle admired: Moderation, commonsense, restraint, modesty and integrity. In that regard, one of the most important laws of investing is that nobody can outsmart the market nor predict what stocks will do in the short-term. Admitting this is the start of wisdom but requires equanimity that many investors lack. After all, virtues such as moderation and restraint are rare.

Graham (the classic investor) made at least five important contributions to investing. First, he came up with the concept that investors, when they buy stocks, should think of themselves as becoming partners in a business. It is the frame of mind that helps keep investors from selling a stock simply because it has gone down and that deters them from obsessing about its daily price. Second, investing like a special kind of baseball game where investors can simply stand at home plate and wait for your pitch. In this game, they cannot call them out on strikes, so they swing at only what they can love. Third, Graham stressed the idea of a 'margin of safety' trying to buy companies for substantially less than they are worth. Fourth, he invented the notion of 'Mr. Market'; he is the manic-depressive partner of all investors. Every day, he offers some business jobs to exploit his mood swings, buying when he is deeply pessimistic. Fifth, Graham taught (in Buffett's words) that you should "look at (market) fluctuations as your friend rather than your enemy, profit from folly rather than participate in it."

However, investors flock the stock market with the intention of earning higher returns. While the temptation drives many to the stock markets, it is only a few who establish a track record of unblemished success in beating the stock market time and again. The most important element to understand when investing money is the power of time. James K Glassman, author of *The Secret Code of the Superior Investor* says, "If he could teach investors only one thing, it would be to use time to your advantage and never get into a situation where time is against you."

Investing is not a one-time affair. To gain the maximum returns in investment, one needs to develop the habit of putting money into an account. Small sum of money put in regular intervals would go a long way in future. Another possibility is to start small and gradually increase the monthly investment amount as one's income increases. Making investing a regular habit is the best chance to acquire wealth. Glassman argues that investing can be hard, but not in the way people expect. According to him, there is constant struggle against marketplace-generated 'noise' and he asserts that the way to make money is not to snap up the hottest stock and then sell it at precisely the right moment. He explains that success requires persistence, ignoring the 'noise' and keeping your eye on the long-term result. Glassman advocates in his book the benefit of long-term strategy over short-term gains, and his cogent advice is to buy fundamentally strong companies and hold them for a long time. He makes simple sense out of a glossy and hyperactive stock market and assures the long-term investor that the market can be a friend, not a foe.

Strategies for Successful Investing: An Insight

- Investing is a serious endeavor, which aims to accumulate assets to help you live better in the future. It's not a game. If you want to 'play' the stock market, then the author's suggestion is that you open a separate account with money you can afford to lose. Also, done well, investing is boring. Attempts to make it exciting by trading shares or simply by watching the ticker and responding to it almost always lead to losses or diminished gains.
- Diversify, diversify, and diversify. Recent news about alleged self-dealing knocked the stock of Enron, the big energy and trading company, down by more than 50% in just a couple of weeks. Enron had been recommended by many smart analysts, and, from all outward appearances, it was a good company. People who bought the stock at $60 were not necessarily foolish, but people who made Enron 10% or more of their portfolios definitely were. You can afford mistakes and bad luck if you have winners who make up for your losses, and the only way to do that is to own diversified portfolios of stocks: 20 or 30 companies spread across industries.
- Stocks are for the long-term only meaning that you should hold a stock portfolio for at least five years, changing its components only if something significant has happened to the company itself, and not if the price of its stock has risen or fallen. Bonds are for the intermediate term, and cash is for the very short-term basically, for living expenses and emergencies.

Winning the market

The big thing in today's markets is that how to make a profit? Writing down the goals and resources is the first step for any superior investor. Actually, buying the assets like stocks, bonds and cash vehicles is second. And acting sensibly after buying those assets is third. No one, of course is able to follow a life plan precisely, but it is absolutely necessary before one can buy single share of stock or any other investment. Timing is the most important factor in investing, more important than which stocks or bonds one can invest or when he buys or sells them. The reason is compounding. Each year you earn a small return on your original investment. But as time goes by, you also earn a return on the returns.

There are two kinds of investors: Outsmarters (believe they're so clear they can beat the system through inside advice and superior brainpower) and Partakers (understand that the best way to make money is to share in the profits of successful businesses). Many investors especially baby boomers, who are convinced they were born more brilliant than everyone else, begin their investing careers as outsmarters. They invariably get outsmarted themselves. Other outsmarters are bottom fishers. They figure they can identify stocks that have plunged but will soon emerge from the depths. Partaking, on the other hand, is the ticket to success in the stock market. Mike Kwatinetz, author of *The Big Tech Score: A Top Wall Street Analyst Reveals Ten Secrets to Investing Success* says, "To win on Wall Street you don't need to listen 24/7 to Investment periodicals like *The Wall Street Journal.* What you need to do is focus. It is better to know a lot about a little than a little about a lot. Choose a handful of stocks, dedicate at least 10 hours a month to follow them, and make yourself an expert. If you have less than 10 hours a month to devote to research, buy fewer stocks. This will increase your risk."

Believing that after the pain comes the gain is yet another mistake committed by investors during a bear phase

Investing efficiently

Regarding buying and selling, investors too often make mistakes. To maximize returns, investors should have entry and exit thresholds and should not consider stock market investing as a game. Believing that after the pain comes the gain is yet another mistake committed by investors during a bear phase. In a declining market, the focus should be on restricting losses. Investing too conservatively or taking unnecessary risks could prove to be wrong decisions in a bear market. "The best way out is to diversify investments. Another piece of advice is not to listen to market prognosticators, since they do not have an iota of idea of the recovery they talk of. An investor would be well advised if he does not believe in the comments made by brokers and financial planners during a bear run, says Edward M Yanis, the author of the book *Riding the Bull, Beating the Bear.*

There are three popular schools of strategic investing—fundamental analysis, technical analysis and efficient markets. Each school approaches the questions of security selection and market timing differently. Fundamental analysis falls into two groups, growth investing and value investing. Value fundamentalists analyze companies, industries and the economic and market environments to identify

stocks that are undervalued at their current market prices. Growth fundamentalists try to identify companies with high growth potential before that potential is reflected in the market price. Stock prices are determined by three factors at work: First, a properly recognized change in value, second, a more or less erroneous change in investors' perceptions of value and third, investors' emotions.

The most common psychological pitfalls in investing are overconfidence, fear of loss, and deep regret over errors besides overlooking opportunity cost etc. A calm rational approach would go a long way in minimizing the impact of these psychological factors. Another major psychological factor is the inability to stick with an investment style and strategy. Though an investor might have formulated a clear plan of investment as per his investment objectives, it is rare that he sticks to it. The dynamics of the stock market do not allow an investor to stay calm. If the stock is not performing as per expectations there is an urge to sell out. Stock market gyrations can be instrumental in driving investors into frenzy. One way to avoid this pitfall is to write on a piece of paper, the investment strategy, along with the reasons for adopting such an investment strategy. A look at the logic thought out in quieter times would minimize the chances of going beyond the chosen investment strategy.

Risk falls as time flies

In financial jargon, risk is usually defined as volatility—the ups and downs of an investment's return. Volatility affects behavior, and prudent behavior is the key to success. The rational response may be to buy more, but the real response of most investors is cold fear, leading to an impulse to sell, often at the wrong time. Taken individually, stocks are wildly volatile in the short-term and moderately volatile in the longer-term. Taken together in an index, for example they are very volatile in the short-term but less volatile than bonds in the longer-term. Says Glassman, "The way we measure volatility is by standard deviation, which tells us how much an investment's return varies above or below its longer-term rate of return. The one-year standard deviation of Standard & Poor's 500-stock index is 20%, which means that it produces returns in two-thirds of all years that fall between 20 percentage points higher and 20 points lower than the average or from 31% to -9%. That's volatile! But economist Jeremy Siegel found that when you hold stock portfolios for 10 years without selling them, the 10-year standard deviation plummets to just 5%. And if you hold a basket of stocks for 30 years, volatility dwindles to almost nothing a standard deviation of 2%. The lesson is clear: Hold stocks long enough and they become no more risky than bonds. That may be the most important principle of the Secret Code of Superior Investor."

The most common psychological pitfalls in investing are overconfidence, fear of loss, and deep regret over errors besides overlooking opportunity cost

Look forward, not backward

The world keeps changing, but many people refuse to change with it. Average investors invest in what everybody else is talking about. They don't have the time or the inclination to study reality or to do the work necessary to dig for an under-appreciated opportunity. There are lots of ways to determine the value of a stock. But the big boy's baseline is the Price-to-Earnings (P/E) ratio. You can find the P/E ratio listed in the business section of the most major newspapers, but the E this paper used is last year's earnings per share. That might be fine for the average blue-chip behemoth, but the authors target high-growth companies. High-growth companies need to be looking forward to stay on top, and so should the investor. Mike Kwatinetz opines that a company's value should always be judged based on its future prospects, not its past performance. Remember the future is more important than the past.

The fate of any one business is utterly unpredictable; but history shows that the fate of the stock market as a whole is closely connected to the fate of the economy, which has been awfully consistent for the past 60 years. Mike Kwatinetz suggests that the lesson for any investor is that owning just a few stocks, or even a lot of stocks in one sector, invites trouble. Giving representation to sectors reflecting the entire economy makes them reasonable returns. However, Glassman recommends that don't try to invest by making projections about the economy. Such predictions are impossible, even for professionals, and they don't matter anyway. The basic assumption that all stock investors should make is that the US economy, over stretches of five years and more, will perform roughly as it has in the past, with GDP growth of a little less than 3% after inflation each year. If one lacks the faith to use such an assumption as the foundation of one's investments, then he should not be in stocks at all. Get into short-term bonds. Investing is the practice of partaking in the growth of a company and ultimately in the growth of US and the world economy.

N Janardhan Rao

ITC

Driven by diversification

Leveraging on its core skills and assets that are already employed in its various businesses, ITC is foraying into new businesses. The objective is to enhance the wealth generating capability of the enterprise and deliver superior shareholder value.

ITC, India's foremost private sector company with a market capitalization of around Rs. 200 bn and a turnover of Rs. 100 bn has a diversified presence in cigarettes, hotels, paperboards and specialty papers, packaging, agribusiness, branded apparels, packaged foods and confectionery, greeting cards and other FMCG products. While ITC is an outstanding market leader in its traditional businesses like cigarettes, hotels, paperboards, packaging and agri-exports, it is rapidly gaining market share even in new businesses—branded apparels, greeting cards and, packaged foods and confectionery. This is a company diversified into various fields ranging from tobacco to apparel. Recent forays in the FMCG sector prove the moot point in question.

ITC's diversified status originates from its corporate strategy aimed at creating multiple drivers of growth anchored on its time-tested core competencies, unmatched distribution reach, superior brand-building capabilities, effective supply chain management and acknowledged skills. Over time, the strategic forays into new businesses are expected to garner a significant share of these emerging high-growth markets in India.

It is now evident that the company is trying to leverage on its core skills and assets that are already employed in its various businesses towards its mission to enhance the wealth generating capability of the enterprise in this globalized environment, delivering superior and sustainable shareholder value. This is in principle called as diversification. By that we can call ITC, a highly diversified company.

Earlier, ITC's packaging and printing business launched a line of high quality greeting cards under the brand name 'Expressions'. ITC has also entered the Lifestyle retailing business with the Wills Sport range of international quality relaxed wears for men and women. ITC has spun-off its information technology business into a wholly-owned subsidiary, ITC Infotech India Limited, to pursue more aggressively emerging opportunities in this area.

Business philosophy

ITC continues to concentrate on core businesses—cigarettes and tobacco, hotels, packaging and paperboard. This is a strategy that every business house is following these days. Tobacco is the prime earner for the company. Although the growth of the industry has slowed down by almost 6%, it has not affected the figures for ITC, which still commands a market share of 65%. It is because of importance it gives to its front-runner business of selling cigarettes. This is always ensured that each of its businesses meets the three criteria of sustainability (in terms of market), profitability and internal vitality. The company has the policy of exiting from businesses, which do not meet these criteria within an agreed time-frame. All these criteria are decided before any project is undertaken and which makes it easy to formulate policies and guide principles.

Its other retailing businesses are running at negative PBIT, taking the toll on the PBIT growth of the cigarette business. Although there is considerable increase in the turnover of other retailing businesses, the charges are still not covered. Probably the time-frame, within which other retailing businesses are to be made profitable, is still not over. Although some businesses, which were profitable earlier are into rough weathers now, that is not true with ITC alone but, it is a common trend in the respective industries of those businesses. The company is known for its quality, production facilities and hotels, and it has won numerous national and international awards for quality, productivity, safety and environment management systems. ITC was the first company in India to be rated for corporate governance by ICRA, which accorded it the second highest rating, signifying "a high level of assurance on quality." The company constantly launches contemporary products, which can adjust with the market changes, which is evident from the recent launch of flour and bischips, which are targeted at youth, who are the main money-spinners in these days of consumerism. Keeping the positioning right is the key to success.

It is a known fact that major chunk of ITC's operations are in the premium segment and so the new forays. This is the most important strategy that ITC employs. Its motive to grow is made secured by creating new businesses, which leverage the strength of its core competencies, residing in various businesses. ITC leverages on its distribution network, marketing skills, brand building and

promotions. It can also be called as better asset utilization if the existing capacities in such operations are harnessed and the expertise in these fields are capitalized.

Despite its obvious strengths, things are not exactly fruitful for India's premier cigarette manufacturer. Legislation on cigarette sales in some states has hit volumes. Kerala, which imposed a ban on smoking in public places and Tamil Nadu, which levied a luxury tax on cigarettes have witnessed a decline in cigarette sales. Several states have imposed restrictions on cigarette sales at railway platforms. Almost 60% of the earnings of this industry go to the government treasury and other state levies. This sector is also mired with unequal burden of excise distribution.

Cigarettes apart, even hotels and paper businesses are mired in problems. A downturn in the Indian paper industry over the last four to five years has seen ITC-Bhadrachalam post heavy losses, leading to an erosion of net worth. ITC was forced to pump in more money in the business to ensure that ITC-Bhadrachalam did not sink. The hotels business is also far from being a winner. Like the paper business, ITC Hotels is facing the brunt of a decline in the fortunes of the hotels business.

What future holds

Recently, it has also entered the red-hot market of wheat flour and biscuits (bischips). The company is trying to capitalize on the same network. Though the retailers are not the same for all the businesses, the distributors can remain the same. Although this fits into the strategy of diversification and suits the mission statement, this is a totally different ball game. It can utilize but cannot boast of capitalizing on its strengths by entering this eatery section.

Financial Summary				
	No. of Months Year Ending	12 31/03/00	12 31/03/01	12 31/03/02
Sales	Rs. mn	10,826.0	9,925.0	9,447.0
Sales growth	%	–	-8.3	-4.8
Gross profit margin	%	5.6	7.0	7.0
PAT	Rs. mn	419.0	466.0	478.0
PAT growth	%	–	11.2	2.6
RoCE	%	22.4	21.3	19.9
RoNW	%	22.3	21.6	19.8
Debt to equity ratio	x	0.1	0.0	0.0

Source: Equitymaster.com

It is a known fact that competition is severe in the field and even the established players like HLL are finding it difficult to play hard with the local players. Some local players have beaten the big players in their field of brand building and marketing (Ghari detergent and Shaktibhog *atta*). It is to be seen that how ITC plays its cards and makes this venture successful. Even VST has ventured in the business of natural products, but now that has run into trouble. VST is planning to divest its non-core businesses. Although there is no comparison between the two companies, even then, this case is important from the point of view of the chosen market. ITC has positioned all its other forays in the premium segment when the market at the bottom level is picking up. Whereas VST, which kept the positioning right could not make it to the finals. Although ITC has championed the art of selling premium brands and even today it has a market share of 65%, it has come down to the masses for harvesting real fruits of diversification.

Looking at the fact that the tobacco industry is under tremendous pressure because of increasing taxes and adverse public reactions, there is an apparent threat to the company's core activities. ITC stocks are also not enthusiastic to the investors because the sales volume of cigarettes is falling. It still commands a premium at 74% of market share (value terms), where others viz., GTC, Godfrey Philips and VST, are fighting their day out. At this juncture, how much risk the diversification has hedged is a moot point. Earlier, ITC stocks had posted highest volumes on the exchanges and had moved the market either way single-handedly. The then market leader is now relegated to backbenches. This only serves to underscore the importance of ITC's cigarette business. So long as hotels and paper businesses suffer setbacks, it will be cigarettes that will propel growth. Even shareholders are keen on the core of this company. The stock price movements also show the disapproval for the latest venture, which can be interpreted by the downward movement during the last three to four months. Given the 4-5% projected growth in cigarette volumes over the next few years, ITC will continue to pursue a price-led growth, as it has premium positioning.

Amol Kshirsagar

Reference # 1-2003-06-16

ITC: History of Diversification

1975	Launched hotels business.
1979	Entered the paperboard business.
1985	Set up Surya Tobacco Co. in Nepal.
1990	Acquired Tribeni Tissues Limited, and set up the International Business Division (IBD) for export of agri-commodities.

International Financial Integration

The process of financial integration across the globe has been increasing over the last decade. The research paper addresses the dynamic behavior of rates of return, the links between rates of return on the international investment position and various financial market returns and the inter-relations between domestic and foreign real rates of return and real exchange rate fluctuations.

With the restriction on capital account and other barriers to investing abroad have been curtailed in many countries, the activity in international financial markets has increased markedly over the last decades. Especially, during 1990s, the foreign assets and liabilities of advanced economies have grown rapidly relative to GDP, with the increase in gross cross-holdings far exceeding changes in the size of net positions. Moreover, the portfolio equity and FDI categories have grown in importance relative to international debt stocks. The research paper addresses issues like, What are the relative contributions of valuation changes (such as stock market and currency fluctuations) and new capital flows in determining gross international investment positions? Has the composition of country portfolios systematically changed over time? To what degree does the increase in external assets and liabilities reflect valuation effects due to the stock market boom of the 1990s?

In the financial integration process, stocks of foreign assets and liabilities represent an important global linkage. Like financial problems in Country A have an impact on Country B via revaluation and other wealth effects. This will be stabilized to the extent that the international balance sheet hedges domestic risks, but potentially raises volatility if external investments leverage domestic positions. Besides, identifying the sources of growth in world asset trade can contribute to an understanding of its sustainability and likely future trends. In this regard, growth that is related to the once-off elimination of barriers to asset trade will not persist but rather represent the transition to a higher level of activity. In contrast, growth that is linked to positively trending variables such as output per capita and goods trade can be predicted to continue into the future.

Data issues

The paper explores international financial integration by using data on countries' portfolios of external assets and liabilities. These data summarize total holdings by domestic residents of financial claims on the rest of the world, and non-residents' claims on the domestic economy. Following the methodology of the Balance of Payments Manual 5 (IMF, 1993), external liabilities are divided into five main categories: Foreign Direct Investment (FDI), portfolio equity investment, portfolio debt investment, other investment, and derivatives. Assets are instead divided into six categories: The same five as liabilities, plus official reserves. The research attempts to use a set of homogeneous data as possible, taking into account both structural breaks and methodological differences in the calculation of assets and liabilities.

Broad trends

A summary volume-based measure of international financial integration is

$$IFIGDP_{it} = (FA_{it} + FL_{it})/GDP_{it}$$

where FA and FL refer to the stocks of aggregate foreign assets and liabilities, respectively. This ratio has increased by 250% over the period 1983-2001 for a set of industrial countries. This increase in financial linkages has not been uniform across countries during the 1990s.

Since international trade in debt instruments may be driven by special factors, the paper also considers an equity-based measure,

$$GEQGDP = (PEQA_{it} + FDIA_{it} + PEQL_{it} + FDIL_{it})/GDP_{it}$$

where EQA (L) and FDIA (L) are the stocks of portfolio equity and FDI assets (liabilities). In other words, GEQGDP is an indicator of the level of equity (portfolio and FDI) cross-holdings. The growth in this ratio has been even more rapid than for IFIGDP—it has more than tripled over 1983-2001. One possible reason for this rise in international financial cross-holdings is the increase in international trade, which has also been substantial in recent decades. Both ratios show substantial increases over the period: In the aggregate, international asset trade has grown far more rapidly than goods trade by this measure.

Going by the relation between the percentage change in the financial openness to GDP ratio and the percentage change in the trade

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openness to GDP ratio during the period 1991-2001, only for Canada (which measures portfolio equity at book value, and therefore underestimates external assets and liabilities) and Japan has trade openness increased more than financial openness. In theory, international financial integration may simply reflect financial deepening. In industrial countries, financial assets and liabilities increased much faster than GDP over the past two decades, and the share of external assets and liabilities in total financial holdings may thus have remained unchanged.

The research paper next investigates the degree to which the value of international portfolios is related to the boom in equity valuations during the 1990s, rather than an increase in capital flows. The data on the change in external assets and liabilities between end-1995 and end-2000 (as a ratio of GDP in 2000) clearly shows the remarkable increase in the size of the country external portfolios, and the magnitude of the underlying gross capital flows. The increase in external diversification is particularly high in financial centers such as Switzerland and the UK, and small open economies such as the Netherlands and Scandinavian countries, and is much faster than in previous years. Indeed, compared to the previous five-year period (1990-95), gross capital flows more than doubled, both in absolute terms and as ratios of GDP.

Another notable fact is the importance of capital gains and losses in explaining the dynamics of the external position. These are primarily due to exchange rate fluctuations and changes in stock market values, which were substantial during this period. In the sample, a remarkable case is Finland, where the increase in the market value of its equity liabilities (in particular Nokia, a stock widely held by non-residents) implied an increase in external liabilities unexplained by new inflows of over 100% of its GDP.

International investment positions – Conceptual issues

The size of the domestic financial sector plausibly facilitates international asset trade in several ways. Domestic financial intermediaries that also distribute international assets offer a local channel by which investors can gain foreign exposure. Exposure to domestic financial markets may also increase the desire for international diversification. On the liability side, an extensive financial infrastructure is attractive to foreign investors. However, a substitution effect may also operate: By necessity, domestic agents will have to invest on foreign markets if the domestic financial sector is underdeveloped. The quality of domestic financial regulation may also be important; foreign investors will stay away from markets that do not protect their interests. Tax policy may also influence the level of international cross-holdings. Firm assets may be shifted to countries with low corporate income tax rates.

Results

The investigation of returns on investments on individual investment categories, the paper first shows that the aggregate returns on foreign assets and liabilities depend on the composition of the international balance sheet between equity and non-equity components. Returns on foreign liabilities show that the return on foreign portfolio equity liabilities moves together with the domestic stock market index return and this specification has high explanatory power. This close relationship is a demonstration of international risk sharing in action; selling shares to foreign investors hedges the risk of fluctuations in domestic equity returns.

Comparing returns on foreign assets to domestic market returns further extends the analysis of returns on foreign assets. The first specification shows that the return on foreign assets positively and significantly co-varies with the domestic stock market, but the elasticity is quite low and the explanatory power limited. Hence, holding foreign assets provides some diversification against fluctuations in the local stock market. Real return on foreign assets shows that the domestic bond return is also positively correlated with the aggregate return on foreign assets, but with elasticity well below one-half, which is again consistent with a diversification contribution from foreign assets. International cross-holdings appear to provide diversification against fluctuations in domestic market returns.

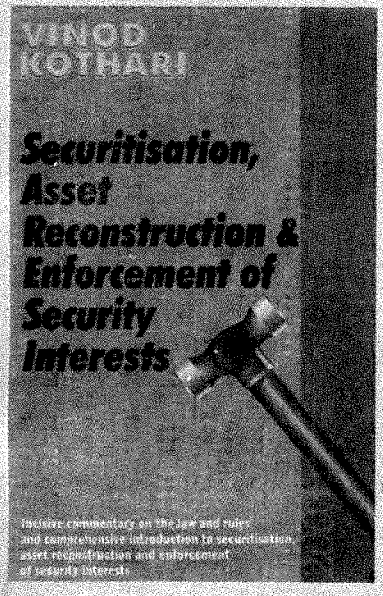
Finally, the dynamics of real exchange rates imply that the properties of real returns are very different for home and foreign investors.

Conclusion

In addition to describing the broad trends, the research identified growth in goods trade and stock market capitalization as two key co-variants of the growth in the scale of international balance sheets. It concludes that better information on the composition of international portfolios would allow a more detailed investigation of this topic but the paper believes that the international investment position data provide a useful and fresh perspective on the international diversification literature. The study of higher-frequency data on rates of return would also be useful in modeling the international transmission of business cycle shocks.

N Janardhan Rao

Indian Securitization Law



Author: ***Vinod Kothari***
Pages: *543*
Price: *$65*
Publisher: *Academy of Financial Services*

Securitization, Asset Reconstruction and Enforcement of Security Interests

The book is the first comprehensive and incisive coverage on the recent law on securitization, asset reconstruction and enforcement of security interests. Besides dealing threadbare with the provisions of law, the book also provides the reader a thorough grasp of the concepts of securitization, asset reconstruction and the rights of secured lender.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 is an extremely important piece of legislation. Implemented in proper spirit, it can provide safe harbor to secured lenders and may encourage larger investor participation in corporate finance. On the other hand, if lenders step beyond the borders of 'security interest' and claim general property interests in secured assets, the law would lead to chaos and litigation.

Securitization is yet another financial instrument that helped banks and companies to raise more than $6.8 tn globally. It is to be seen if the present piece of law structured as an enabling legislation helps banks and financial institutions effectively tap capital markets for banking assets.

Securitization

Securitization in its widest sense implies every such process, which converts financial relation into a transaction, more specifically into a capital market instrument. There seem to be new receivables that are amenable to securitization. However, the traditional securitization receivables possessed some features. The entities taking the securitization route had substantial part of the assets in the form of receivables. Entities where receivables form a small portion of working capital may not find it economical to go through the securitization route. However, these entities are participating in securitization market through conduit activities. The receivables securitized must be receivables already created i.e., right to receive over time, for something already done by the originator. The receivables which are to be securitized must have a reasonable predictability. Moreover, receivables which are diversified would be preferred for securitization, as investment in diversified receivables reduces risk.

Just like any organized markets securitization is necessary to the economy. Securitization facilitates creation of markets in financial claims, which would otherwise have remained bilateral deals. Securitization disperses holdings of financial assets. The basic intent of securitization is spreading financial assets amidst as many savers as possible. In this way securitization also promotes savings. Perhaps one of the peculiarities of this instrument is that once an entity securitizes its financial claims it ceases to be the owner of such resources. Securitization also smoothens the impact of recession. During 1991 when the US economy was passing through recession securitization was roaring with record issuance.

Securitization has many benefits to the issuer. It reduces costs to the issuers. Securitization seeks to break an originating company's portfolio into echelon of risks, trying to align them to different investors risk appetite. In this way the overall cost of company that has securitized its assets seems to be lower than the company that depends on lower funding. Securitization gets in the alternative investor base. It brings in a new class of investors. As securitization is an asset-based financing, it makes it possible even for a lower rated company get a better rating based purely on the strength of the asset quality. As securitization is an off-balance sheet financing tool it gets with it certain benefits. It helps banks and other financial entities, which are required to meet the capital adequacy ratio requirement, as it allows the financial entity to sell some of its assets and thus remove them from the balance sheet reducing the amount of capital required for regulatory purposes. On the other hand, the investors benefit as securitization is a better security. The investors have the direct claim over the asset. Securitized instruments also have a better flexibility to match with the investment objective of the investors. Overall, they offer good yield with adequate security. History has also proved that they are fewer instances of default.

Focused measures to help the banking system realize its non-performing assets has resulted in creation of specialized bodies called Asset Reconstruction Companies

On the down side, the aggregate of securitizing assets is theoretically expected to be lower than the cost of mainstream finance; in actual experience securitization has been shown to be costly, especially in the emerging markets. The huge upfront costs in the form of rating fees and legal costs also add to the heavy initial payment. This might prove uneconomical to companies, which require lower sourcing.

The first chapter introduces securitization and its specific features. Clarity is brought between securitization and structured finance. Securitization as a risk management tool is also seen. The other prominent topics covered in these chapters are the economic impact of securitization, types of securitization, advantages and disadvantages of securitization and the risks of securitization. The chapter has important quotations and articles from some popular publications including Bank for International Settlements. Some case studies also put the chapter in perspective.

Asset Reconstruction Companies

As the problem of non-performing loans created due to systemic banking crises world over has become acute, focused measures to help the banking system realize its non-performing assets has resulted in creation of specialized bodies called Asset Reconstruction Companies. These companies are helping to fight NPAs in the banking sector. This chapter talks about asset management companies and various models which have evolved over the period. The problem of NPAs and the idea of asset reconstruction companies in India give the background to the topics. The global experiences in United States, Mexico, Japan, Korea and some South-East Asian countries are also shared.

Enforcement of security interests

The chapter looks at the law of security interests and the global

About the Author

Vinod Kothari is internationally recognized as trainer, consultant and expert on securitization, credit derivatives and asset-based funding. A Chartered Accountant and Company Secretary with brilliant academic record, Vinod Kothari wrote a book on Lease Financing and Hire Purchase at an young age of 23, which is still today regarded as the most authentic text on the subject.

In addition, Vinod Kothari has written *Securitization: The Financial Instrument of the New Millennium* Y2K edition, which sells all over the world. Another recent book *Credit Derivatives and Synthetic Securitization* is one of the very few comprehensive treatises on the subject. Through distance training as well as workshops in 15 countries all over the world, Vinod Kothari annually trains 500 executives at all levels on complex financial topics.

Author's Exclusive

Casual law-making is one of the biggest mistakes we are making as a nation. My book on the SARFAESI law, besides being an incisive commentary on the much-talked-about law on recovery of NPAs, is a medium to bring home the point that the very basis of our democracy is at stake if the lawmakers continue to enact laws which have a loose language, vague purpose, and overwhelmingly regulatory stance even where the objective of the law is promotional. Increasingly over the past few years, we have been handed down both statutes and subordinate laws which are drafted with the least respect for founding principles of law.

The SARFAESI Act was intended to serve several purposes: Promote securitizations, bring into existence "bad banks" which will pool together NPAs of banks and try to realize them, and make enforcement of security interests faster. The Government somehow thought of merging these into one—my observation is that the sole purpose was political convenience. This merger itself made a mockery of the whole concept of securitization as the lawmakers muddled the concept of a securitization SPV with an asset management company for NPAs. The whole device of securitization was grossly misunderstood when the lawmakers thought of securitization as a business, while it is nothing but a mode of funding. Thus, the train went off the rails at the inception and then, there were oddities of all sorts added: A capital adequacy requirement etc., while securitization SPVs are not expected to have anything more than a bare minimum net worth. Not surprisingly, after nearly one year of the passage of the law, the securitization market continues to ignore the SARFAESI law as falling under its discipline is neither obligatory nor advantageous.

Sketchy legal provisions were made for asset reconstruction companies, for which guidelines have been finalized by RBI only on April 23—nearly after 11 months of the promulgation of the Act. These guidelines, among other things, require an ARC to pay in cash or non-contingent bonds for purchase of a defaulted loan, which by itself would remove much of the incentive for the buying ARC.

On the most sensational part of the dealing with enforcement of security interests, the whole message that has gone into the banking system is flawed. The SARFAESI law does not, and cannot, give any more powers to the banks than the loan agreements do. The law is concerned not with enforcement of loan transactions, but with enforcement of security interests. A security interest originates from the loan or security agreements, and it is this, and this alone, that can be enforced under the SARFAESI law. The law casually talks about takeover of management of assets, or takeover of management of a unit of the borrower, which is out of question unless such power is given in the loan documents.

The purpose of this law is not to give a free hand to the banks: Banks will have to stay within the confines of the loan documentation and only exercise such powers as are explicitly granted in the loan documents. In many cases, the security interests held by banks are floating charges, which do not relate to any specific assets. The applicability of the SARFAESI law, which is primarily concerned with enforcement of security interests by taking recourse to measures on some assets of the borrower, is doubted, if the charge is undefined or unascertainable, as a floating charge is.

Another major confusion is that this law does not give a right to a borrower to go to an appropriate forum for injunctions. This is completely misplaced. Though the law does oust civil jurisdiction on matters specifically vested in a DRT, the ouster will be applicable only in those cases where a right is granted to the DRT. If a right is not granted to DRTs to grant injunctions, the right remains with the civil courts.

I hope my book will invoke thoughtful readers to do serious thinking on this very sensitive piece of law, and I will be benefitted if readers get back to me at vinod@vinodkothari.com for suggestions, comments or critique.

concerns of the rights of the secured lender. The concern as to the rights of the secured lender is economic rather than legal. The law has only been shaped to meet economic objectives. The objective is to impart a certainty to asset-based lending to attract wider investor participation in financial markets. The essential features of security enforcement law as per World Bank working paper and the security enforcement law in India are also covered.

SARFAESI Law

The preamble of the SARFAESI law hints at the purpose of this law. The dominant theme of the law seems to be regulatory. The Act merges into one, three separate pieces of draft legislation. The three

parts are securitization setting up asset reconstruction company and provisions relating to registration and enforcement of security interests. There is an element of commonality as well as confusion that has resulted from the fusion of these three elements into a single piece of legislation. For example the requirements of asset reconstruction companies have been applied to securitization companies as well. Provisions for registration of security interests have also been made applicable to transfers in connection with securitization and provisions which ought to have excluded the applicability of the security interest matters have apparently eluded securitization and reconstruction transactions as well. Broadly speaking, the statute could be of the following types—Enabling statute, Regulatory statute, Penal statute and Fiscal statute.

The book starts from the basics and the concepts are explained clearly. Extra care is taken by providing guide to explain the finance jargon to the readers who are reading this concept for the first time or readers who are not familiar with the topic. The author has seen the concept from various angles. Every concept is also seen from the point of view of all the parties concerned.

It also talks in depth about the different types of instruments like pass through, pay through and CMOs. The book compares and contrasts these instruments. The topics of securitization are compared with factoring and ring fencing. The book puts the concept in perspective by talking about the evolution and the present stage of asset reconstruction companies in India and problems specific to India. The global experience especially in US, Latin America, Japan, South-East Asia—Korea, Malaysia, Thailand, Indonesia and China are also shared.

Securitization seeks to break an originating company's portfolio into echelon of risks, trying to align them to different investors' risk appetite

The part of the book talking about the Act contains the valuable comments of the author. The author analyzes the Act critically. The book also touches on other acts like the Companies Act. It also has some chapters dedicated to the Subordinate legislation and Reference legislation. To make the learning more interactive and updated the book also provides for a free Web-based update.

The book is well-written and can make an easy reading. The book is based on recent data. The tables, graphs, flow charts and box items give a pictorial look and helps the reader understand the concept clearly and most importantly quickly. The appendix supplements the chapter. The index of cases, statutory instruments certainly makes the navigation easier.

Overall, the book is complete as regards the new Act. Securitization, Asset Reconstruction and Reinforcement of Security Interest are seen critically. This book is certainly a body of knowledge on securitization and the new Act. This book is a must for professionals including bankers as it deals with the subject practically. This book is also recommended for students and research scholars who like to broaden their horizon and would like to know more on securitization, the new Act and all the related areas.

D Satish

Snapshot

- Deals threadbare with each section of the sensitive piece of law, exploring the intricacies, anomalies and giving appropriate comparative view of common law, civil law and law in other countries.
- The book also contains all subordinate laws available to date with rules and directions with comments wherever required.
- The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 is an extremely important piece of legislation. Implemented in proper spirit, it can provide safe harbor to secured lenders and may encourage larger investor participation in corporate finance.
- Securitization is yet another financial instrument of our times, the instrument has already helped banks and companies to raise more than $6.8 tn globally.
- Entities where receivables form a small portion of working capital may not find it economical to go through the securitization route. However, these entities are participating in securitization market through conduit activities.
- Securitization facilitates creation of markets in financial claims, which would otherwise have remained bilateral deals.
- The concern as to the rights of the secured lender is economic rather than legal. The law has only been shaped to meet economic objectives.
- The SARFAESI Act merges into one, three separate and for most parts the unrelated pieces of draft legislation. The three parts are securitization, setting up Asset Reconstruction Company and provisions relating to registration and enforcement of security interests.

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August 2003

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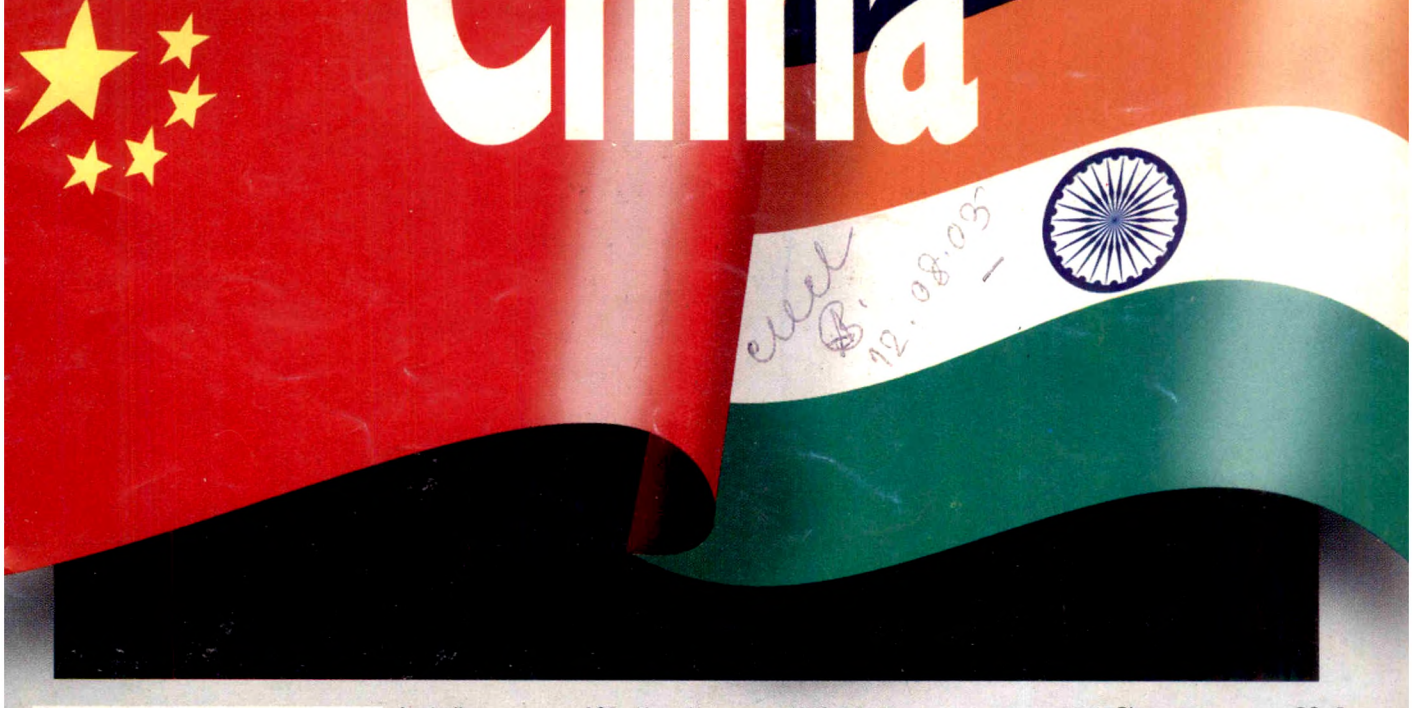

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ISSN 0972-5053

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Printed and published by E N Murthy on behalf of The Institute of Chartered Financial Analysts of India, The ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh. Printed at M/s ICIT Software Center Pvt. Ltd. (Press Division), 3-112, Fatehnagar, Sanathnagar P.O., Hyderabad - 500018, Andhra Pradesh and published from The Institute of Chartered Financial Analysts of India, The ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh.
Editor: E N Murthy

In the Dragon's Way

The tale of the two Asian neighbors is a curious mix of striking similarities as well as dissimilarities. Apart from being the two most populous countries in the world they also have large domestic markets. However, the similarities end here. China achieved huge economic success, as a result of its reforms that preceded long before India woke up to reforms. China has also emerged as the new manufacturing base of the world. India is way behind it and has a lot to do in order to catch up with the dragon. There is clearly a case for India to learn from the experience of its neighbor.

Much of India's laggardness vis-à-vis China is ascribed to two factors. First, the democracy, and secondly, the first mover's advantage China got by way of embarking on reform bandwagon much ahead of India. Having an autocratic regime has been a big advantage for China as decision-making is fast.

In India, decision-making is a long, arduous process, which is further worsened by a lack of mechanism to ensure timely implementation. However, what the democratic set up has ensured is that decisions are based on consensus, which has a better impact on the populace. Besides being a consensus based society, India also offers an open culture, has a better legal, accounting and governance environment and so on. One of the important areas which India needs to learn from its neighbor is labor reforms. India needs to embark on the process of retraining of idle labor and create job opportunities for them.

The fact that China has got the first mover advantage need not be perceived as a deterrent. This could be made possible through increased collaboration in areas of complementary strengths. India can help China in building its skills in knowledge-based industries such as IT and pharma whereas China can offer valuable lessons in labor-intensive industries such as leather, textiles, and electronic goods manufacturing. Further, India would do well to embrace an economic model that focuses on industries where it can build competitive advantage to go beyond IT and other related services and ensure that a large part of its masses are engaged in the efforts to achieve economic prosperity.

India's reforms began out of compulsion created by economic crisis, as compared to China's which was a proactive step. Given the way the reforms are progressing in India, and the unfinished agenda that still hangs in balance, it appears that India is yet to learn its lesson to get proactive.

It is a strange fact of history, that the nation that built the Great Wall broke the walls that stood against its reform to achieve economic prosperity. Whereas, India, one of the biggest democracies, has built stronger invisible wall—the lack of will to proactively reform.

Ch Rajeshwer

Letters to the Editor

Interesting Story

I have gone through the recent cover story on deflation in the *Analyst* and found it to be very interesting.

Lokanandha Reddy Irala
Convener, Dhruva Globe India Network

Timely Debate

I found the debate on credit derivatives very timely and informative. As financial markets become more and more developed, such sophisticated risk management instruments are bound to become important. In this context, RBI's decision to allow banks to use credit derivatives is a welcome measure. However, when it comes to implementing them there could be umpteen issues as discussed in the debate.

Ravi Kumar
Ranchi

Pension Issues

The article on pension funds was really an eye-opener. Pensions have been more or less taken for granted by many Indians. But as we shift from state-owned economy to an economy that is dominated by private players, pension is going to become an important issue. In the developed world, demographic shifts are already jeopardizing established systems of social security. India can take a few precautionary measures before it actually faces the problem.

P Sweta Menon
Thiruvananthapuram

Verbatim

The capabilities of supervisory staff have to be enhanced, specifically their understanding of accounting, information technology and finance. Specialists...have to be hired. Skimping on...salaries is the worst form of under investment.

– Raghuram Rajan, newly appointed Chief Economist, IMF, on improving bank supervision in India.

Let the government not put money into information technology, let it only make it easy for foreign direct investment to come into the country.

– N R Narayana Murthy, Chief Mentor, Infosys, in a CII conference on IT's role in creating a developed India.

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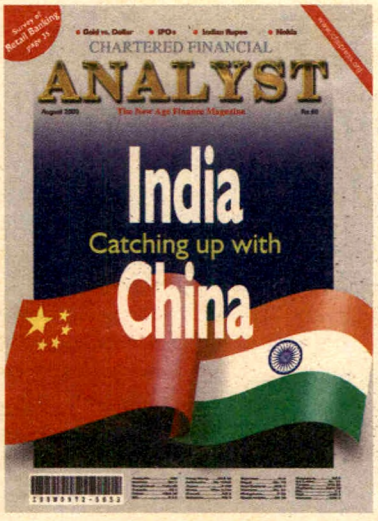

Cover design by A Bangaru Babu

India: Catching up with China 19

India shares a minuscule 1% of the $8 tn world trade, more than 70% of which is in the area of processed manufacturing. China, on the other hand, shares around 3% of the world pie and continues to dominate the world with its newly acquired status as the manufacturing hub of the globe. However, the situation might change for the better, if India Inc.'s latest level playing with the dragon is any indication. But taking the dragon on its own turf, in a game in which it dominates the world, would not be an easy task for India. Is India Inc. ready?

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Gold: Will the Glitter Remain?

Ever since touching 21-year nadir in July 1999, the price of gold has been rising steadily since then. From a low of $252.85 on July 20, 1999 gold price rose to 36% on July 15, 2003. Since then the price of gold is holding up. What has contributed to this phenomenal rise in the price and why is the price sustainable?

Dollar and gold interface

The major influencing factor seems to be the falling dollar. The war in Iraq, the conversion of the budget surplus to deficit, the plummeting stock market and the weak economy with the possibility of deflation has brought down the dollar. The unofficial willingness of the US Government to accept the weak dollar has certainly not helped either. This brings us to the question as to why the weak dollar spelt good for gold.

From the Bretton Woods era the US dollar was denominated in terms of gold and various other currencies were denominated in terms of US dollar. This is how the value of gold got linked to the US dollar. The countries kept their foreign exchange reserves in dollars and gold. But with the worrying economic indicators from US, the governments all over the world are looking towards reducing the dollar reserves and increasing the proportion of gold. Some governments like that of China are betting on gold and euro rather than dollar. So this clears the inverse relationship with the US dollar and gold.

Best bet

Apart from the falling dollar the absence of opportunity for investors led by the stock market downturn has seen the investors going in gold. Gold is also the most universally valued metal with a wide market. All this has contributed to the rise of gold prices.

Bright future

Now this brings us to the question as to whether the price of gold is sustainable at the higher level and the future direction of the price of gold. The US probably has the key to this question. With the largest reserves of gold US could bring the prices of gold down but US feels that it is in its best interest that the prices of gold remain stable rather than speculative. The falling dollar has also, in effect, made the US goods competitive in the global markets and has reduced the budget deficit. With the US Government not willing at the moment to involve in a big way the price of the gold is all set to move up. Experts feel that the post war economy would favor gold as a safe haven due to the expected low interest rates and the continued sluggish stock markets.

D Satish

IPO: Revival in the Offing?

Maruti's IPO came as a monsoon shower in the draught-ridden Indian primary markets. It was more than welcomed by the stock markets, which have been putting up lackluster performance over the last couple of years. The issue is special for more than one reason. It is the first time, the government chose the route of equity markets to divest its stake; it is one of the few times, retail investors participated so overwhelmingly, oversubscribing the issue by almost 10 times. In addition to the obvious boost to the primary markets, the issue of Maruti has a greater symbolic significance.

A forerunner

Getting out of business has been a messy affair for the government. The ambitious targets of disinvestments proceeds set up in the budget every year remained nothing more than numbers on paper. The actual proceeds were only a meager amount when compared to the targets. The process of disinvestments itself has been very painful—rift with political opposition, employees' agitations and a generally unfavorable atmosphere. Even as the economic compulsions and the reforms agenda forced the ruling parties to go on disinvestments, the ground realities only stifled the plans. However, there is a slow but sure change in the attitude towards disinvestments. From the days when Balco was sold out in a strategic sale to Sterlite Industries to the time CMC was sold to TCS and VSNL to Tatas, there has been an increasing acceptance of disinvestments as an indelible economic reality. Given such a background, the reception of Maruti IPO would have brought a sigh of relief to the disinvestment. This method of going to the equity markets seemed to have gained more favor than the process of strategic sale. There is every possibility that the government would choose this route for Nalco, IBP, HPCL, BPCL and other PSUs that are lined up for disinvestment.

Reviving the equity markets

The Indian primary markets have not seen much action in terms of IPOs in the last couple of years except for an occasional issue from the banking sector. In tune with the global trends the Indian equity markets too have been on a downtrend with retail investors largely staying away from the markets. But the surprisingly large participation of the retail investors in this initial offer raises hopes about the revival of the equity markets. In fact, many companies that were planning to tap the markets had shelved their plans fearing that the markets would not be receptive. May be this deal would boost their confidence and encourage them to tap the markets.

D G Prasuna

Asia's Economic Superpowers

China's economic growth has been truly remarkable. Its reforms are aimed at encouraging international trade and foreign direct investment. However, India started its reforms much later, and it's behind the curve as compared to China. The Chinese approach to reforms is different from what other nations have done so far. Instead of a top-to-bottom approach, the Chinese opted for a bottom-to-top approach. This enabled the Chinese authorities to gain the support of masses. Having the right approach is a prerequisite for success and that is the key for China's success.

As long as the Chinese economy continues to grow, India will be forced to reform to keep up. China has more coherent leadership, is more business-friendly and a much stronger international profile, so it will be way ahead. India has world-class intellectual skills and the advantage of English fluency but needs to simplify its business environment. India relies too much on the skills of individuals whereas China relies on its ability to organize skilled labor to build up enterprises and invest capital. As things stand today, China is way ahead of India in terms of presence in the global marketplace.

In terms of economic potential and global aspirations, however, China and India are both giants. Each country has a considerable pool of resources at its disposal, which if harnessed and channeled appropriately, could be used to catapult each country towards their true potential. India's experience with economic liberalization is more recent than China's; it is more prone to political roadblocks. India's is still a relatively insulated economy compared to China, which has already shown a remarkable ability to integrate itself into the global economic marketplace.

It is important to note that simply having an economy that is valued at a trillion dollars does not equate with general prosperity. Both countries have critical milestones that need to be reached in the form of enhancing productivity, transparency, participation by many, financial position etc., before they can credibly be incorporated into the club of prosperous nations. Both countries have large population, mostly rural with urban centers of industry, a commitment to education even if only a portion of the population possesses high levels of human capital. But, perhaps most importantly, both countries share a focus on the importance of science, technology and promote industries, which incorporate advanced skills. As technology is the key to growth, with continued commitment on this front, it would not be unexpected of India to become the next success story.

N Janardhan Rao

Rupee: Hinging on US Economy

Nearly after a decade of depreciating against the dollar, Indian rupee is showing signs of appreciation since the past one year. Though this appreciation is the result of economic and related aspects, it was least expected that rupee could ever appreciate for such a long period of time. On the other side, rupee has been continuing its trend of depreciating vis-à-vis other major currencies like euro and yen. At the same time, dollar is depreciating against euro and yen. This clearly indicates that the rupee's appreciation comes at the backdrop of global economic outlook. While a host of other factors are helping the rupee to appreciate, the debatable issue is whether these factors can sustain the momentum.

One of the factors that is acting strongly in favor of rupee is the economic outlook. The prolonged slowdown is taking its toll on the US economy and the Fed's attempt to revive the economic growth by maintaining low interest levels is not bearing fruits. On the contrary, low interest rates are prompting the global investors to look out for alternative investment avenues like emerging markets where the interest rates are high.

While the US interest rates are hovering around 1%, interest rates in India are higher by around 5-6%, thus attracting the global investors. This high interest rates are also prompting the non-resident Indians to invest in Indian Government bonds thus pumping foreign exchange into the Indian economy.

Added to the interest rates factor, reasonable economic growth backed by manufacturing sector, foreign currency reserves and good investment climate have contributed to the appreciation of rupee.

While the appreciation of rupee may continue into the future, the reversal of trend may in all probability depend on the timing of the revival of US economy.

Dr. Alok Ray, Professor of Economics, Indian Institute of Management, Calcutta, says, "The future movement of rupee against the dollar depends on many unpredictables like the timing of US recovery, the interest rate policy of the Fed, the future investment climate in Europe vis-à-vis US, the political and economic developments in the Arab world." To sum up, it all depends to a large extent on the revival of the US economy. Though at present the expectation of 3% economic growth looks optimistic, if the US economy grows much faster than the EU economy, then further outflow of investments from the US economy is unlikely. In such a scenario, the dollar will appreciate against euro and other major currencies resulting in correction in the valuations vis-à-vis rupee.

Y Chandra Sekhar

NATIONAL

IMF admires India

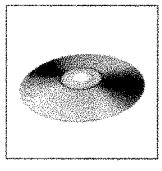
Going by India's strong balance of payments and comfortable foreign exchange reserves, Kenneth Rogoff, the outgoing Chief Economist, International Monetary Fund (IMF) praises India. It is a healthy sign that India was no longer borrowing from the multi-lateral agency, he observes. "IMF had projected a good growth for India but the question is what will it take to achieve the 8% rate as outlined in the Tenth Five-year Plan. The reforms have slowed down but the reason is not clear," he says. Encouraged by India's strong economic fundamentals, IMF, for the first time, selected India to become a member of its Financial Transaction Plan (FTP). Accordingly, India contributed $205 mn to the FTP, thus turning from a debtor to creditor of the IMF. The decision to select India as a member of the FTP sends a strong signal about the country's strength and the resilience of its external sector to the international community. Advocating the need for flexible exchange rate, particularly in other Asian countries, Rogoff says, "If one restrains appreciation of exchange rate then one will witness an upward pressure, which in turn could result in pushing up the inflation level."

RBI raises forex remittance limits

Buoyed by the strong build-up in foreign exchange reserves, the Indian bank regulator took yet another step on the road to current account liberalization. It raised the limits for remittance of foreign exchange by 3-20 times for various purposes, ranging from education to employment abroad. The limits on remittance of foreign exchange have been raised by 20 times, from $5,000 to $100,000 for those going overseas for employment, for those emigrating and for the maintenance of close relatives abroad.

For those who are studying overseas, the limit has been raised from $30,000 to $100,000. Banks may allow remittances for amounts up to the new limits for each category without insisting on supporting documents but on the basis of a self-declaration incorporating the basic details of the transaction and the submission of an application. The banks could henceforth release foreign exchange up to $100,000 or its equivalent to resident Indians for medical treatment abroad, without insisting on any estimate from a hospital or doctor in India or abroad.

India's top IT exporter



Tata Consultancy Services (TCS) has been ranked as the top IT software and services exporter in the country by the Tata group company, which registered revenues of Rs. 4,545 cr (Rs. 45.45 bn) during 2002-03, was followed by Infosys Technologies and Wipro Technologies with revenues of Rs. 3,543 cr (Rs. 35.43 bn) and Rs. 2,787 cr (Rs. 27.87 bn) respectively, according to Nasscom's Top 20 IT software and service exporters in India (excluding the ITES-BPO sector) rankings.

The combined revenues of the top 20 software and service exporters in the area of IT services, products and technology services was Rs. 20,746 cr (Rs. 207.46 bn) in 2002-03, an 18% growth over revenues of Rs. 17,607 cr (Rs. 176.07 bn) posted in 2001-02. The Indian software and services exports industry recorded revenues of Rs. 34,800 cr (Rs. 348 bn) in 2002-03, an 18.4% rise from Rs. 29,400 cr (Rs. 294 bn) in the previous year.

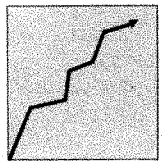
Cause to cheer

India's 13-cr-strong farming community has some cause to cheer, with the Finance Minister's announcement that crop loans of up to Rs. 50,000 made by public sector banks will henceforth attract a maximum annual interest rate of 9%.

This decision will provide a fair bit of relief to farmers reeling under the burden of costly loans. The overall impact of the latest initiative will, however, be limited on two counts. First, the move pertains to only crop loans meant for Seasonal Agricultural Operations (SAO).

Second, it is to be adhered to by only commercial, that too public sector banks [including Regional Rural Banks (RRBs)]. Commercial banks and RRBs accounted for only 45% of the estimated Rs. 44,929 cr of institutional crop loans during 2002-03, with cooperative banks providing the remaining 55%. To make crop loans from cooperatives more affordable, the Finance Minister opined that the government would introduce legislation in the coming Monsoon Session to enable the National Bank for Agriculture and Rural Development (Nabard) to provide direct refinancing to District Central Cooperative Banks (DCCBs).

Slight advance in US industrial production



The US industrial production posted only a slight advance in June 2003, but manufacturers saw their biggest output gain since January, the Federal Reserve says in a report. Overall production at American factories, mines and utilities rose 0.1% in June, the Fed says, while the amount of capacity in use held steady for a second straight month at 74.3%. Factory production, which makes up more than four-fifths of overall industrial output, rose by 0.4%, its biggest gain since January. The report was precisely in line with Wall Street analysts' expectations. In May factory production was up by 0.1%, giving factory output its first back-to-back monthly gains since July and August 2002. Manufacturing capacity also ticked up in the month, rising to 72.8% from 72.6% in May. The numbers provide a glimmer of hope for the beleaguered US factory sector, which has shed almost three million jobs since March 1998, pushing manufacturing payrolls to their lowest levels since 1958. The sector has been hit hard by companies' unwillingness to invest in new plants and equipment during the 2001 recession and the sluggish economic recovery.

Greenspan to testify again

Federal Reserve Chairman Alan Greenspan will get another try on impressing Wall Street when he goes to Capitol Hill for the second part of his closely watched testimony on the economy. Greenspan pledged to keep interest rates low for a while and predicted stronger economic growth. The reaction in financial markets fell far short of applause. Not only did Greenspan say it was unlikely he would raise rates any time soon but he held out the possibility that the Fed might cut borrowing costs again if it becomes necessary to ward off the threat of deflation. The treasury market staged a huge sell-off. The 10-year bond's yield, which moves in the opposite direction to the price, posted the biggest one-day rise since October 1998. Predictions from the White House of a record $455 bn budget deficit contributed to the rout in treasuries. Amid worries about the bond market's reaction and its implications for the cost of long-term credit, stocks sold off in tandem.

Robust PC sales

Dell Computers consolidated its lead in the worldwide personal computer market, as aggressive pricing and the shift toward portable computing contributed to surprisingly robust global demand for PCs in the second quarter of 2003. Worldwide PC shipments rose between 7.6 and 10% during the quarter, substantially above expectations, says IDC and Gartner, two market research groups. The range in growth rates was due to statistical variations between IDC and Gartner.

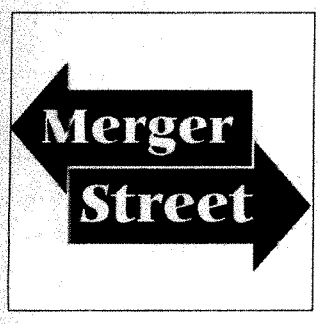
IDC says the data marked the fourth consecutive quarter of positive growth and represented the highest increase since the end of 2000. IDC had anticipated that PC sales would grow 4.1% in the quarter. Gartner also cautioned that a sustained improvement in PC sales would depend on economic conditions and it noted that corporate IT budgets remained tight. IDC figures showed Dell captured 17.8% of the worldwide market, while HP increased its share to 16.2%.

SARS – No impact on the dragon

Notwithstanding the outbreak of SARS, Foreign Direct Investment (FDI) to China during the first half of the year rose sharply by 34.33% to $30.26 bn, surpassing the half-way mark of the targeted record $60 bn. According to the Ministry of Commerce, during the January-June period, contractual foreign investment topped $50.958 bn, up by 40.25%. During the first six months of the year, 18,877 new overseas-funded enterprises were approved in China, up by 22.3%, *China Daily* reported.

By the end of June 2003, China had approved a total of Rs. 443,073 overseas-funded ventures, with contracts worth $879.02 bn and actual investment of $478.22 bn. The FDI inflow in June was hit by the outbreak of SARS, the paper says citing a mere 2.48% growth during the month. In June, the total amount of FDI received was $6.98 bn, up by 2.48% when compared to the same period last year. Also, the number of newly established foreign-invested companies totaled only 3,702 last month up just 0.79% from June 2002.

Experts says that the SARS outbreak could have cost China $1 bn in FDI in the second quarter. But they said it will soon come back and China's FDI is still likely to reach its target of $60 bn this year. Contracted foreign investment, an indicator of future trends, rose a still robust figure of 34.67% year-on-year to $12.74 bn in June.



$65 bn worth M&A in 2003

The first half of 2003 has been very happening as far as the Mergers and Acquisition scenario is concerned. The total worth of deals as of the first week of July is around $65 mn. After the tepid M&A scenario last year, this comes as a welcome development. There have certainly been some mega-merger deals such as First Data's $6.9 bn bid for Concord EFS. The top ten deals announced are as follows:

Acquired	Acquirer	Deal Value (in $ bn)
Concord EFS	First Data	6.9
Biogen	IDEC Pharmaceuticals	6.8
Hughes Electronics	News Corp	6.6
PeopleSoft	Oracle	6.3
Ocean Energy	Devon Energy	3.6
First Virginia Banks	BE&T	3.3
Scios	Johnson & Johnson	2.3
Dana	ArvinMeritor	2.2
JD Edwards	PeopleSoft	1.7
Clayton Homes	Berkshire Hathaway	1.7

Biogen merges with Idec

In the biotechnology industry the second biggest ever deal took place when Biogen merged with Idec Pharmaceuticals. The two major players in the industry were brought together in an all share deal worth $6.8 bn (€5.9 bn). The merger follows the consolidation trend in the industry where several smaller players have already merged. Analysts believe that the deal was about the two companies making themselves too big for a large pharmaceutical group to swallow. This is the second largest deal in the biotechnology sector after Amgen's $10 bn purchase of Immunex in July 2002.

Both the companies are profitable; Idec's cancer treatments generated about $400 mn in revenues last year while Biogen's treatments for multiple sclerosis, hepatitis and other diseases had sales of $1.1 bn. Many believe that most of the synergies from the merger are likely to be derived from cost-cutting.

Citi buys Sears credit card

Citigroup (Citi), the biggest US bank is all set to include Sears credit card to its portfolio of financial services. Citi has agreed to pay $3 bn to purchase the credit card unit of retailer Sears. This is probably one of the last big deals to be made by Sandy Wiell, the outgoing Chief Executive of Citi.

Citigroup has made no secret of its emphasis on consumer financial services and this move only strengthens the initiative. Sears' credit card portfolio is the eighth largest in the US and would be a perfect fit for Citi. Citi is already the biggest issuer of bank credit cards, and this deal would position it as a leading player in private label cards as well. In financial terms, citigroup would be managing card receivables of $169 bn after the deal, nearly twice as much as the next two banks combined.

According to the deal, Citi has agreed to pay 10% premium for Sears' assets which are presently around $29 bn, which are expected to raise to $30 bn by the time of the closure of the deal. That puts the price at $3 bn. Sears will get to keep with itself $3 bn cash from the card business. This puts the whole pay off for Sears from the deal at $6 bn.

From issuing store cards, Sears had moved into bank cards, which brought trouble with them. The loss rates in the bank card accounts obtained through direct mail were three times more than the industry average. However, Citi was attracted by the core of customers with good track records and relationships with Sears.

Sears portfolio has 59 million accounts, 25 million active. Of the cards, 58% is private label and will carry the Sears name. Citigroup will gain access to 2,700 retail locations as a part of the deal.

EMC to buy Legato

The US data storage group EMC plans to acquire Legato systems in a stock transaction worth about $1.3 bn. According to the deal, Legato stockholders will receive 0.9 EMC shares for each Legato share. Shareholders are yet to approve the acquisition, which would be completed by the fourth quarter of 2003. David Wright, current Chief Executive of Legato, will remain the head and it will work as a separate division of EMC.

Legato is a supplier of hierarchical storage management systems. The addition is expected to strengthen EMC's capabilities in data access and recovery and add a software-focused division to its global operations. Company sources believe that the merger would improve EMC's abilities to protect its clients' information. They expect to report a net profit throughout 2003.

AOL to sell CD unit

The troubled media conglomerate AOL Time

Warner (AOL) is in all probability to sell off its compact disc and digital videodisc-manufacturing unit to the Canadian group, Cinram International. The deal is worth about $1 bn. The exact details of the deal are being hashed out. Cinram had cash and cash equivalents of C$164.2 mn (US$118.2 mn) at the end of last year. It is expected to fund the acquisition with a mixture of debt, cash and new equity. After the acquisition Cinram is expected to gain control over seven factories producing CDs, DVDs and printed materials for Warner Music.

AOL has reported a staggering loss recently and has been divesting stake in some of its businesses as a part of its debt reduction strategy. AOL had a debt of $29 bn at the beginning of 2003 and it aims to cut this amount to $20 bn by the end of the next year. AOL had already sold its 50% stake in the Comedy Central cable channel to Viacom for $1.23 bn. There are a number of other chunks of its multifaceted business that are being put on the bloc to rope in some valuable dollars.

PeopleSoft's deal complete

PeopleSoft has successfully rushed through its acquisition of JD Edwards worth $1.8 bn. Soon after the PeopleSoft-JD Edwards deal was announced Oracle had entered the foray with an unsolicited and unwelcome offer to buy PeopleSoft. The bid put the JD Edwards deal in jeopardy. However, PeopleSoft did pull the deal off.

Industry experts and observers believe that the success of this merger would add a premium to PeopleSoft. Which in turn would be instrumental in fending off Oracle. However, Oracle is far from being disenchanted by the addition of JD Edwards to PeopleSoft. With much of the attention focused on the more important bid from Oracle, the efforts for integration of JD Edwards into PeopleSoft would be put on the back burner for the time being.

The reaction of the Department of Justice to Oracle's offer to PeopleSoft would decide the future course of action for Oracle.

Another deal in business software

The merger activity in the business software industry continued as Business Objects, a software company owned by France's most prominent software entrepreneur, Bernard Liautaud agreed to buy Crystal Decisions (Crystal) for $820 mn.

The deal would make Business Objects, the biggest player in one of the fastest growing corners of the software industry, business intelligence software. Both Business Objects and Crystal specialize in business intelligence software, which is used to dig down into the various information systems to produce management reports of companies. This segment of the software industry has been on high growth track as seen by the revenue increases at Business Objects and Crystal. Revenues at Crystal Decisions grew by a third in the year to March to $270 mn, while those at Business Objects increased 9% last year, to $455 mn.

Transport companies merge

Yellow Corporation (Yellow), a trucking company is all set to acquire rival Roadway in a cash and stock deal that is valued at about $966 mn. According to the terms of the deal, Yellow values Roadway at $48 a share with that sum evenly split between cash and stock. In addition, Yellow will also assume $140 mn debt of Roadway.

The combined company is to be called Yellow-Roadway and will have an annual revenue of $6 bn with international operations. Yellow Chief Executive Bill Zollars will remain in charge of the combined entity, while Roadway CEO James D Staley will continue to run that part of the company as a separate unit. The deal brings together two of the largest trucking companies in the transportation industry. Roadway is known for its tech-savvy approach. The company has used technology to cut costs, track workers and on the whole, to increase its competitive edge over other players. As per company sources the synergies from the merger are expected to flow from the leverage of 'service capabilities and technologies'.

BB&T completes the deal

BB&T Corporation has completed its purchase of First Virginia Bank by paying $3.05 bn. The deal was announced in January 2003. The deal would give BB&T the No. 2 deposit market share in state of Virginia. First Virginia is the parent company of eight community banks and 363 branches. It is also one of the 25 largest auto lenders in the US, through its First Virginia Credit Services Inc.

The merger is expected to increase the asset base of BB&T by $91 bn, which makes it the 11th largest holding company in US. After the merger, BB&T proposes to introduce other services and products such as online banking, investment banking, insurance, trust, leasing, international banking and mutual funds. According to the terms of the deal, 1.26 BB&T shares were given to shareholders for each First Virginia share.

D G Prasuna

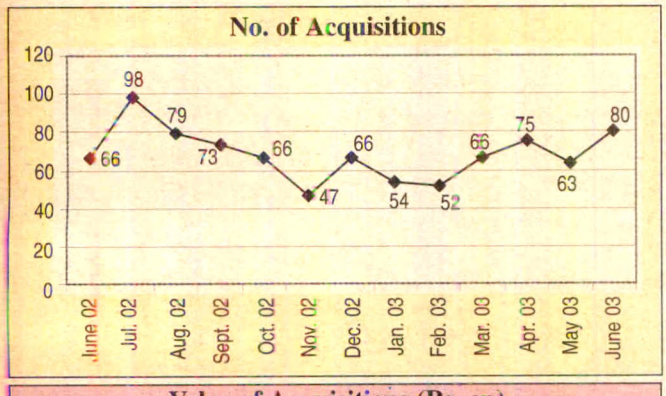
Deal Corner

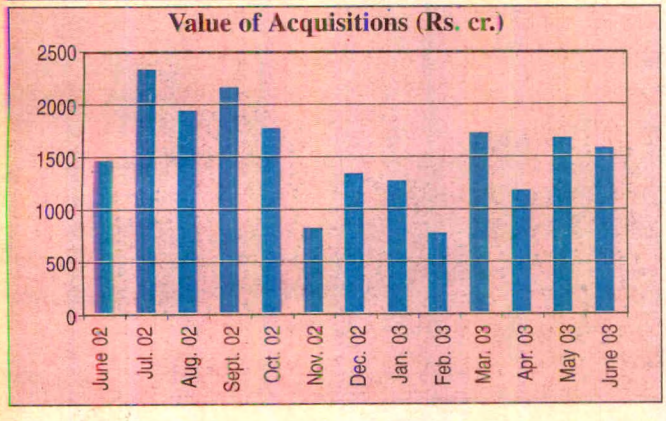
June 2003 saw the consolidation activity in Aditya Birla Group and the group emerged as the market leader in the Indian cement industry. It also consolidated its fertilizer business and forayed into the BPO segment of IT-enabled services sector. All in a span of one month.

Eighty-six M&As aggregating Rs. 1,559 cr were struck during June 2003. This month has seen a rise in the number of acquisitions to 80 which has largely remained low since October 2002. While the number of acquisitions rose, number of mergers saw a drastic fall, with just six mergers compared to 49 during June 2002.

Trends in M&A deals

M&A activity is expected to pick-up in the next couple of months due to Maruti Udyog Ltd.'s IPO and also two deals proposed by L&T. Including open offers, in the first quarter of fiscal 2003-04 (April-June) 254 M&As aggregating Rs. 4,393 cr were announced, compared to 324 M&As aggregating to Rs. 9,580 cr during April-June 2002. While the number of mergers fell by 60% over the period, average value per acquisition nearly halved. Decline is mainly due to decrease in divestment activity as compared to previous fiscal. The government's divestment initiatives were the main drivers for high M&A activity in 2002. M&A activity in the fiscal was mostly in the F&B, chemicals, transport and communication services sector and IT sector. While the pharmaceutical industry saw a decline in terms of number of deals, agrochemicals industry saw increased consolidation.





Month	Industry*	No. of Deals	Corresponding Value (in cr.)
June 02	Chemicals	9	186
	Financial Services	9	369
July 02	Electronics	20	89
Aug. 02	Electronics	13	977
Sep. 02	Chemicals	13	279
Oct. 02	Chemicals	14	274
	Chemicals and Plastics	14	274
Nov. 02	Electronics	11	48
Dec. 02	Financial Services	8	54
Jan. 03	Financial Services	7	135
Feb. 03	Electronics	15	73
Mar. 03	Financial Services	13	300
Apr. 03	Chemicals	15	577
	Chemicals and Plastics	15	577
May 03	Financial Services	13	96
June 03	Ferrous Metals	10	552
	Chemicals	10	39

*Month-wise topper in terms of number of acquisitions.

Month	Industry*	Value (in cr.)	Corresponding No. of Deals
June 02	Electricity	481	4
July 02	Financial Services	265	10
Aug. 02	Electronics	977	13
Sep. 02	Financial Services	1320	4
Oct. 02	Diversified	945	1
Nov. 02	Chemicals and Plastics	319	7
Dec. 02	Electricity	743	1
Jan. 03	Transport and Communication Services	367	6
Feb. 03	Financial Services	182	6
Mar. 03	Chemicals	992	9
Apr. 03	Chemicals	577	15
	Chemicals and Plastics	577	15
May 03	Food & Beverages	669	3
June 03	Transport and Communication Services	590	5

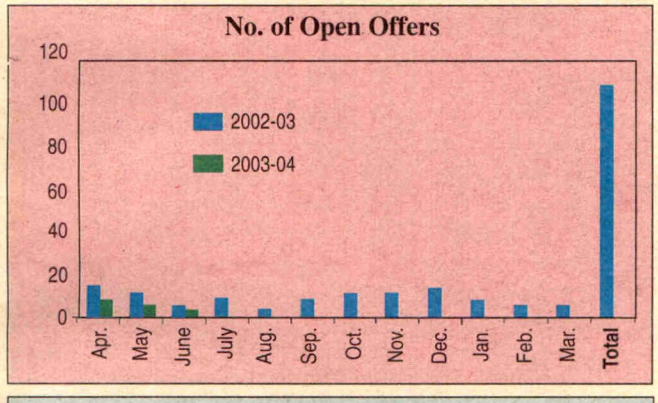
*Month-wise topper in terms of value of acquisitions.

Open offers

Three open offers worth Rs. 85 cr were announced in June 2003. Out of these one was for unlisted company. All the three were made by Indian acquirers and all were consolidation initiatives. In the first quarter of fiscal 2003-04, 17 open offers aggregating Rs. 300 cr were announced, compared to 25 aggregating to Rs. 1,790 cr during April-June 2002. The government's divestment initiatives were the main drivers for high open offers during last fiscal. Aditya Birla Group, with an intention to consolidate its position in fertilizer industry has made an open offer for 20% of the Indo-Gulf Fertilizers. The group already holds 31.53 stake in the company. Sesa Goa has made an open offer for 24.56% of the Sesa Industries. It already holds the remaining 75.44 stake in the company. The open offer of Raipur Alloys & Steel for 20% stake was announced on May 24, 2003.

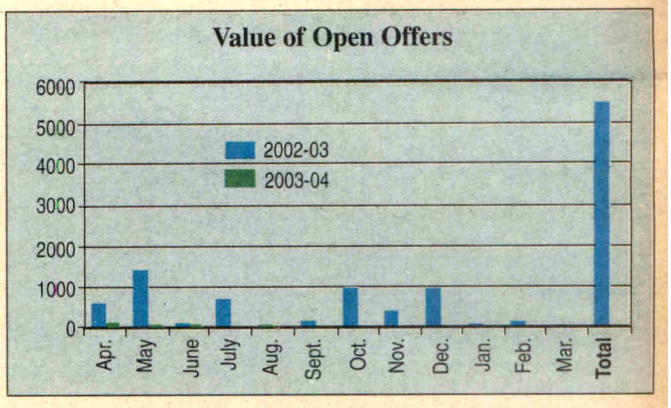
No. of Open Offers

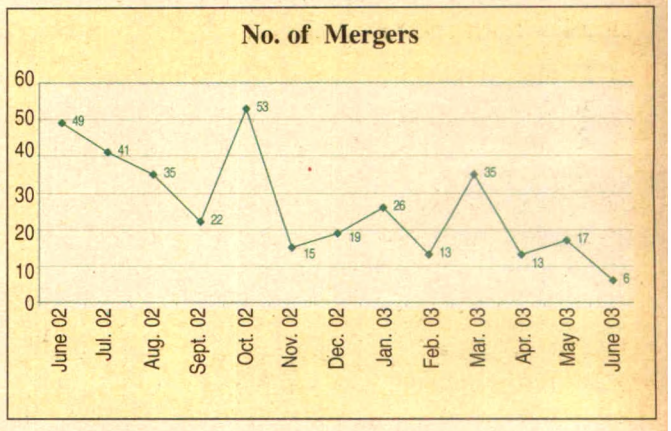
	1999-00	2000-01	2001-02	2002-03	2003-04
April	10	6	6	15	8
May	7	9	7	12	6
June	2	2	4	5	3
July	4	2	10	9	
August	4	6	10	4	
September	3	6	7	8	
October	6	10	5	11	
November	5	2	10	12	
December	18	10	10	14	
January	6	5	10	8	
February	13	3	10	6	
March	11	15	10	5	
Total	89	76	99	109	



Value of Open Offers (Rs. cr)

Month	1999-00	2000-01	2001-02	2002-03	2003-04
April	9.5	38.2	112.6	595.2	124.9
May	138.3	660.8	351.9	1,377.0	23.7
June	11.1	0.6	72.4	76.1	85.0
July	50.4	58.6	63.1	725.4	
August	4.4	2.0	335.4	23.8	
September	14.6	22.3	205.1	147.4	
October	14.6	199.9	110.3	964.1	
November	47.7	43.2	128.2	381.8	
December	138.1	1,047.4	963.6	954.8	
January	38.9	18.7	66.2	66.6	
February	8.5	46.6	1,855.6	130.1	
March	276.2	487.3	526.5	20.4	
Total	752.3	2,625.6	4,790.8	5,464.4	





Acquisition of equity stakes in companies

Shortly after gaining control of Mangalore Refinery & Petrochemicals, ONGC has increased its stake to 71%. By completing Zurich acquisition HDF AMC rose to No. 2 position in mutual fund hierarchy. Indian Rayon & Inds, a group company of Aditya Birla Group has acquired Transworks Information Services, a BPO company. The group has also acquired 25% stake in Star News.

Disinvestments

The Central Government has re-initated privatization of Madras Ferilizers by inviting fresh Expression of Interests (EOI) for divesting 32.74% stake. Central Government has invited EOI for divesting the entire 100% stake in Sponge Iron India.

Buy-backs

Mazda has announced buy-back of shares for 10% stake. Sebi has rejected buy-back proposal of DSP Merrill Lynch and ordered the promoters to make an open offer instead.

A Sowdeepti

JAPANESE BANKS

In deep waters

Japanese banks have been struggling to come to grips with the economic problems. Despite the turnaround initiatives contemplated, the latest Resona Holdings dilemma has raised serious concerns about the Japanese banking scenario and its implications on the economy.

The nightmare for Japanese banks are ongoing. The country's fifth largest bank, Resona Holdings disclosed on May 17, 2003 that the capital adequacy ratio (a key barometer of a bank's health) had fallen dangerously low. Resona was created only in March 2003 by the merger of Asahi Bank and Daiwa Bank. The goal of the group was to become a 'super-regional' bank. The two parent banks of the Resona Group, however, were low-ranking commercial banks. The group's profitability failed to improve following the integration of management, and its business foundation remained weak due to the continuing deflationary situation. A few weeks earlier, the bank had reported a capital-adequacy ratio of 6%. Without government support, it is on the brink of collapse, so what went wrong?

The Resona Group had more than ¥2 tn in non-performing loans, and along with other factors, its base was weak. Besides, an independent auditing firm in May noted that the bank had been overestimating its future income. Resona was forced to revise its deferred tax assets downward—tax refunds that it expects to receive in the future—and its capital adequacy ratio subsequently dropped. In the year 2002, the bank had stated that it had ¥709 bn in deferred tax assets, but the independent auditing firm allowed a figure of only about ¥435 bn in 2003. When this happened, the capital adequacy ratio of the bank fell to 2.07% as against 6% norm. The capital adequacy ratio of Resona Holdings also dropped to 3.78%. A ratio of 4% is the minimum necessary for a bank to conduct business in Japan.

State Minister for Economic and Fiscal Policy and Financial Services Heizo Takenaka, launched the Program for Financial Revival in October 2002 and put forth a formula that would more strictly regulate the treatment of deferred tax assets in the calculation of capital adequacy. Bank experts have noted that banks had previously kept their capital adequacy ratios higher than they should have been through the inclusion of deferred tax credits based on estimates of future profits. Takenaka's financial revitalization program led the auditing firm to be strict in evaluating Resona. Following the big accounting scandal in US, the reality of corporate audits has been called into question in Japan and other countries; so independent auditors need to conduct their audits strictly to ensure that their own credibility is not in doubt.

Worst yet to come?

Following the news of Resona, Takenaka opined that he had not heard of any main banks other than Resona being short of capital. As of September 2002 end, however, deferred tax assets accounted for more than half of the core capitalization of Mizuho Bank, Sumitomo Mitsui Banking Corp., and UFJ Bank and over 30% of that of the Bank of Tokyo-Mitsubishi. Analysts say that although differences between the tax systems make generalizations difficult, banks in the United States can use deferred tax assets to account for a maximum of 10% of core capital, so the figures for major Japanese banks are high by comparison. The weakness of Japan's financial institutions has brought in relief by the case of Resona, and much attention is paid to the financial health of other major banks. In particular, people involved with the market are watching closely to see whether the Resona case will have an impact on other main banks, which are also factoring in large amounts of deferred tax assets. But the viewpoint is mounting that some of them will experience similar problems when they close their books at the end of September 2003 and again in March 2004. Some observers are forecasting a 'second Resona'.

Turnaround – No success in sight?

Mizuho Holdings, the world's largest bank in assets terms, posted the heftiest loss in Japanese corporate history recently, dealing a severe blow to hopes that bigger would prove better for the country's unstable financial system. News of the massive yen loss at Mizuho (the ¥2.38 tn, US$ 20.35 bn) announced this amid wider news of negative results at Japan's mega-banks—formed through a series of mergers aimed at stabilizing a system that has lurched from one crisis to another in recent years. The problems with bad loans, deflation and a nosediving stock market punched a ¥4.6 tn hole in the balance sheets of the seven biggest banks. That combined loss was more than 10% worse than last year. Total losses at the big seven banks in the year to March came to some ¥4.6 tn—about the size of the Nigerian economy. However, the seven banks wrote off ¥5 tn of

bad loans last year, putting them well on course to achieve the government's target of halving the scale of the problem—estimated at about ¥26 tn in March 2002—by 2005. Seeing it as one of the main obstacles to reform in Japan, Junichiro Koizumi, the Prime Minister, and Takenaka, have stepped up the pressure on the banks to change their ways over the past year. The top banks promised a return this year, Mizuho itself forecasting the largest net profit of the top seven groups at ¥220 bn. Investors have heard such forecasts before, but analysts gave them more credence this time, although much depends on the stock market. Top officials at the banks say that their profit projections would depend on effective government policies to stop deflation and boost growth as much as the stock market.

Outlook

The leading Japanese banks have forecasted that they will make net profits in fiscal 2003 although their history of making predictions indicates that these estimates should be regarded as wish-lists rather than a credible assessment of their future earnings ability. SMFG, Japan's second largest bank, forecasts a net profit of ¥150 bn in 2003 compared to a loss of ¥465 bn last year; MTFG, the third largest, estimated a profit of ¥190 bn compared to a loss of ¥161 bn and UFJ a profit of ¥150 bn against a loss of ¥608 bn. The banks all of whom reported 2002 earnings recently were determined to convey the message that the worst is over after enduring a challenging year in which regulatory zeal to implement banking reforms reached a new peak.

However, research from Barclays Capital makes it clear that the banks even in their pre-merger form share forecast profits every year since 1993 but have never been able to match their initial numbers. Despite positive moves to tackle their bad loan portfolios and bolster their capital bases, the banks remain in a weakened position both operationally and financially, indicating one or more of them may be forced to seek a capital injection from the government. Shokichi Takagi, Financial Services Agency (FSA) Commissioner confirms that no other banks apart from Resona need public funds. Even the FSA stated repeatedly before the Resona bailout that no bank was in trouble, undermining his message of reassurance. Analysts say that the banks will struggle to boost earnings significantly in a stagnant economy where deflation is worsening the burden of an estimated ¥40 tn in bad loans. "Whether they can in the long run become profitable is still in doubt," says Hideo Ueki, Chief Investment Officer at UBS Asset Management. He further adds, "They have also been struggling to come up with a business model that is sustainable."

Y Chandra Sekhar

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Relocation Scheme	Those who have been allotted plots by DSIDC.	Acquisition of land, building, plants & machinery and other assets.	50 lacs (incl. of working capital	TL 32.50 lacs (65%) SL 10.00 lacs (25% or Rs. 10 lac max.) (NEF)	10%
Small Road Transport Operators Scheme (SRTO)	Small transport operators to acquire upto 20 vehicles including existing, if any.	To meet expenditure towards cost of chassis, body, building, intial taxes, insurance and registration etc.	Overall assets not to exceed Rs. 12 Crores & Share Capital & reserves not to exceed Rs. 10 Crores.	Rs. 500 lacs for Companies/Cooperative Society & Rs. 200 lacs for proprietory/partnership firms.	15%

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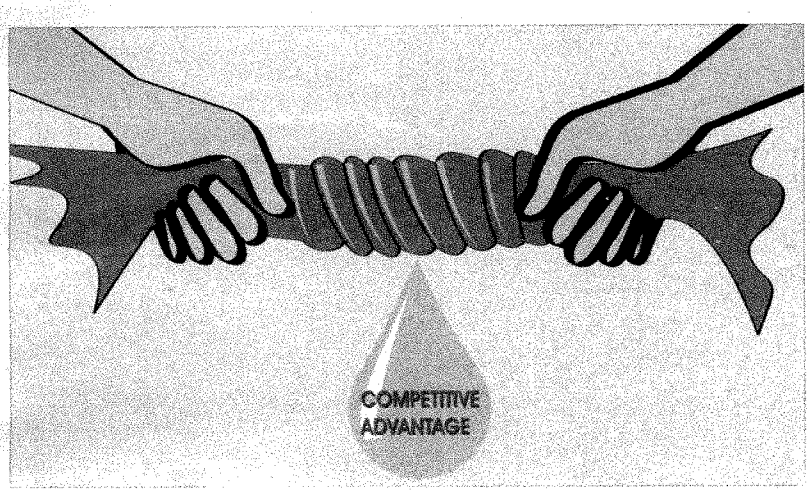
Towards A Greener, Cleaner and Better Environment

INFORMATION TECHNOLOGY

Whither strategic value?

The power of IT has made it abundant, but to be of strategic value it has to be scarce.



IT industry's woes are far from over. Even as it is reeling under a three-year-old slowdown, the very advantages of it, which are what resulted in huge investments in the 1990s, are being questioned. Today, it is widely held that IT has commoditized.

It is cheap, widely available and an essential utility. As a result, experts, the world over, aver that IT has lost its ability to render competitive advantage to companies investing in it. IT, they say, is essential to stay in competition, but it may not be of much use in beating the competition.

IT today is everywhere, making it indispensable for day-to-day business operations. On the flip side though, just because it is omnipresent, it no longer gives 'that' competitive edge. Its strategic value has diminished because everyone can afford and get it.

As more and more people use IT, no one enjoys a unique benefit. But, is it not true that the 'advantages' of a technology has more to do with 'how' rather than 'how many'?

What's IT?

IT essentially refers to the set of products and services that transform data into useful, meaningful and accessible information. It includes all kinds of technology used to create, store, exchange, and use information, which can be of various forms like data, voice, images, motion pictures, multimedia presentations, and the like.

There are two types of technologies—proprietary and infrastructural. When companies innovate, they own a proprietary technology, which is exclusive to them. And, because they are protected they offer strategic advantages to the companies. But, infrastructural technologies are often shared, they form a part of the general business infrastructure. Interestingly, in the early phases, infrastructural technologies can take the form of proprietary technologies, because only a few can afford it and thus have an edge over others.

In the early years, the technologies mentioned above invited huge investments by virtue of their anticipated commercial possibilities, but eventually were mired in overcapacity problems. In the article titled, 'IT Doesn't Matter' (that created quite a stir in the corporate world), published in the May 2003 issue of *Harvard Business Review*, the author, Nicholas G Carr argues that all those technologies opened the doors of opportunity for a brief period for companies, which embraced it early because they were more like proprietary technologies initially. But with increasing availability and the resulting cost reductions, they became commodities. In fact, they no longer mattered strategically. The same holds good for IT. Like with any technology, as IT's power and popularity has grown, its criticality has augmented. As they say, "the more you use it the more you need it." Similarly, it has reached a level where it has become indispensable for any business. At the same time, because it is ubiquitous, its strategic importance has reduced. Why? Because, as the demand increases, there is increasing standardization of the product and with standardization, the edge is eliminated.

The life cycle

Then again the stage of technology, in its life cycle also dictates its importance. Various factors interplay at different stages in the technology development cycle. In the early stages, speed, power and cheapness dictate the demand for technology. The focus is entirely on technology. Then follow the middle stages, where all the earlier mentioned characteristics are taken for granted, as consumers want more, marketing plays the dominant role. Here it is more about seeming different than

actually being different. Lastly when it reaches the maturity stage, neither technology nor marketing provide any differentiation and it becomes a commodity.

The IT industry is now matured and therefore commoditized. As Roger Fulton, VP, distinguished analyst, IT Management Research, Gartner says, "Many aspects of IT have certainly commoditized—PCs, office tools, games, photo imaging, document delivery, etc." But then, he says that a large proportion of the money spent on IT is still spent on highly customized technology and skills—around 20% of the US$ 1.7 tn spent by corporations and consumers last year (excluding telecom services) was on commodity IT products. This leaves about 80% being spent on complex products and skills for enterprises. What it means is that companies still hope to reap strategic advantages from IT.

IT still is a prudent investment. Those who swear by its utility value will anyway invest in it and those who consider it strategically important have to go for it

Strategic value

Over the past decade, IT has expanded rapidly and as more and more people used IT, businesses started considering it as a vital resource. Carr says that as the power and presence of IT have expanded, companies have come to view it as a resource ever more critical to their success, a fact clearly reflected in their spending habits. But, he says, "as IT's potency and ubiquity have increased, so too has its strategic value."

Unfortunately for IT, the strategic value of a resource is a result of its scarcity, and not its abundance. IT's core functions of data storage, processing and transport have become commonplace and cheap. Its 'power' and 'presence' are taking it away from strategic resource basket towards a commodity one. Like the diamond-water paradox, so popular in economics, IT value has diminished with its wide availability. Though, like, water, IT is a must for survival, it is not as valuable as a diamond. It has indeed become a utility, like water and electricity.

It's the usage

But then just because everybody uses it doesn't mean that it becomes a commodity and loses its competitive advantages. Reflect on this: Many retailers use Supply Chain Management systems, but all are not Wal-Marts. Many emulate the direct model, but all of them are not Dells. For that matter, many try to follow no-frills model, but do they all become Southwest Airlines?

So, what would be strategically advantageous? Either you have what others do not have or you use what everybody has in a way others do not. And since IT is what others also have, you use it like no other. Fulton agrees, "Quite clearly IT has enabled many companies to achieve a competitive advantage, but this comes primarily from their ability to exploit IT more effectively than their competitors." The way IT is leveraged largely boils down to the culture of the organization, its innovativeness. In other words, the benefits of IT can be best had by making it a part and parcel of the organizations' culture and structure. Fulton is of the same view; "IT provides competitive parity to the majority of organizations. It is generally people and their ideas that provide competitive advantage through leadership, competence and vision—which includes exploiting IT rather than just following the herd."

Playing the IT game

Game theory says that more the number of people using a particular technology, the better it would become in terms of quality and power, and because it becomes better many more people would start using it. This is particularly true for infrastructural technologies. As more and more people embrace it, the efforts to better it, in terms of security, speed etc., will increase. As it becomes more secure and powerful, more people would adopt it, and the cycle continues.

Each time a full cycle is complete, technology becomes better and better. In this cycle the outcome is Nash Equilibrium as it is a win-win for both the players—consumers and companies. For consumers, technology is more secure and speedier and is also cheaper, while for companies the more the consumers the better the revenue. They work towards bettering the technology to get more people to use it.

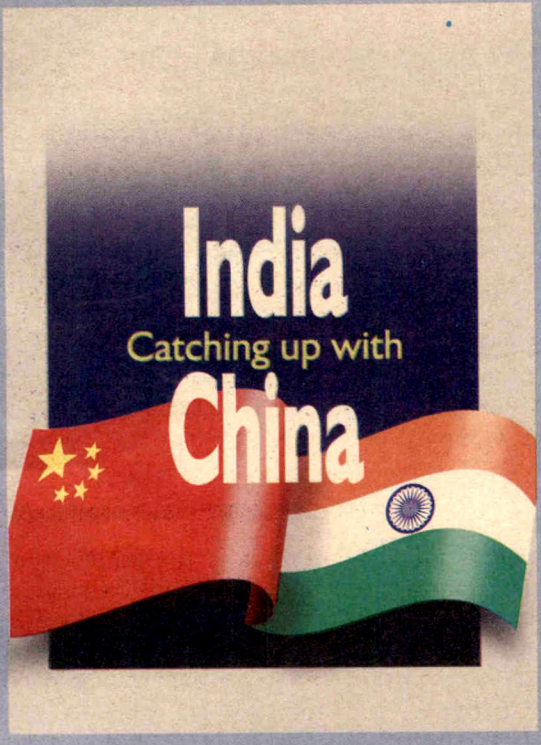
Whichever way one looks at it, IT still is a prudent investment. Those who swear by its utility value will anyway invest in it and those who consider it strategically important have to go for it. So, IT's days are far from numbered.

Philosophically speaking, though it is everywhere and anywhere, "we are a long way from having too much of a good thing with IT—I think we are still in the early days of its infancy—excited by the technology (shiny and bright) and not thinking enough about how to change our behavior and working practices to really exploit it fully," says Fulton. So, these days when the product is same for all, companies have to look for new ways of using it.

Like Wal-Mart, Dell, P&G, Shell and others, companies have to wring the competitive advantage out of IT.

CSV Ratna

Reference # 1-2003-08-03



India shares a minuscule 1% of the $8 tn world trade, more than 70% of which is in the area of processed manufacturing. China, on the other hand, shares around 3% of the world pie and continues to dominate the world with its newly acquired status as the manufacturing hub of the globe. However, the situation might change for the better, if India Inc.'s latest level playing with the dragon is any indication. But taking the dragon on its own turf, in a game in which it dominates the world, would not be an easy task for India. Is India Inc. ready?

India

Catching up with China

Just a couple of years ago when the manufacturing dragon announced its plan to hit the Indian markets with products at abnormally low prices (motorcycles at just Rs. 24,000!), it sent shivers down the spine of the Indian industry. Suddenly, there was a sense of gloom among local manufacturers, as they knew competing with Chinese companies was virtually impossible. For, they lacked the scale which the Chinese manufacturers operated. However, two years down the line, the situation has totally changed. The fear factor has gone and has given way to a new way of thinking—Chinese manufacturers so far have been unable to crack the Indian great bazaar—India's manufacturing minnows can do it. This change was all pervasive during the recent visit of the Indian Prime Minister to China where he was accompanied by a host of entrepreneurs from the country who wanted to explore business opportunities in Mainland China.

Today, several Indian companies from both manufacturing as well as services sectors are either already tapping or are in the process to slew the opportunities offered by China. Companies such as Bharat Forge, Bajaj Appliances, Maharaja Electronics, NIIT and Ajanta Watches are to name a few who have already established a foothold in the world's new 'workshop'. Does the initial success of these companies signal the arrival of the Indian companies on China's manufacturing landscape?

Cracking China's manufacturing code

China's pre-eminence in manufacturing is indisputable today. The country's rise in manufacturing however has not been sudden. Rather, it is attributed to an articulated strategy ably supported by well-executed reform processes over the years. It was this, which helped China to emerge as the world's new 'workshop'. India, in contrast, embarked on the services bandwagon and succeeded well by emerging as one of the world's major IT powerhouses. However, the country, in the meantime, did not pay adequate attention on

developing its manufacturing skills.

About two decades ago economically both the Asian neighbors were on equal footing. However, there after the scenario changed completely as the two economies took different paths. China went for reform measures, while India stuck to its legacy of license raj. China started its reforms process in 1978-79 with opening its economy to foreign competition. Experts opine that the country's relentless focus on developing its skills in manufacturing while looking at the world as its market has helped it gain leadership in manufacturing. India, on the other hand, was late in embarking on the reform process. The country was behind over a decade as economic reform measures were initiated only in 1991-92. However, reforms as compared to China lacked pace here; perhaps this is the price one has to pay for democracy. China being under an autocratic regime has had no compulsion to appease electoral classes so the Chinese reformers were single minded about reforming the country's economy. India's political masters however, on the other hand, have had to not only achieve reform objectives but also ensure that electoral classes were not unhappy.

In fact, the labor reforms in China which took place long back helped it immensely in attracting foreign companies to set up their shops and boost its economic prosperity while India's slow progress on that front has cost it dearly, mainly owing to political compulsions. Another factor for India's relative slow growth vis-à-vis China is its reforms in the area of real estate. China's early move in that direction helped the country witness retail revolution with retail chains being proliferated in the country generating huge job opportunities for the people. Today, the gap between the two Asian neighbors as far as the manufacturing sector is concerned has widened significantly. In terms of manpower, people employed in manufacturing in China are more than twice that of India (95 million vs. 45 million). Further, manufacturing accounts for 35% of China's GDP whereas in case of India it is just 16% of its GDP.

However, opinions vary over the issue of India's relative laggardness vis-à-vis China. Prasenjit K Basu, Managing Director, Robust Economic Analysis (P) Ltd., Singapore, strongly disapproves it saying, "...For the past 20 years, India has had the fastest-growing economy among the democracies of the world with a population of over 5 million (Botswana is the only democracy that has grown faster, but its population is less than 3 million). This is no mean achievement, although autocracies naturally can generate faster growth by suppressing political freedom. That itself is one explanation for the slightly faster growth rate that China has achieved in the past decade (averaging about 6.5-7%, after taking out exaggerations in the reported data) than India (about 6%). I would point to three other key factors that explain the difference. (Read the full text of the interview accompanying this article).

Sanjeev Sanyal, Senior Economist, Asia, Deutsche Bank AG, Singapore, however, observes that there are several factors, which explain the difference between the two countries. He primarily focuses on two major factors, which help understand this comparison. He says, "India opted for liberalization relatively recently compared to China, and then opted for a gradualist approach. There are a number of good reasons for doing things slowly, but it comes with a cost. Secondly, demographics in China has supported very high savings rates that in turn have supported very high investment rates. India's

"India and China complement each other. Through comparative advantage, the countries can take advantage of each other's existing strengths."

Dr. Linda Yueh
Economist
London School of Economics
UK"

population dynamics too will change but it will become optimal only in the next decade—so we will need to wait. Nonetheless, the cumulative impact of a decade of slow reforms is now feeding through the economy and I feel that some parts of Indian manufacturing is now capable of competing with China."

Presenting a rather different perspective Dr. Linda Yueh, Economist, London School of Economics, UK, opines that rather than identifying India's weakness it would be more appropriate to emphasize China's strength, which can shed light on the difference. She remarks, "On account of its socialist system, China has a relatively egalitarian society. This social stability underpins the ability of a centrally planned economy to transition to a more market-oriented one. This process of transition is therefore directed to a large extent by the Central Government where emphasis can be placed on export-orientation, fostering technological upgrading, etc." She says that India is in a different position as its economic development follows more of the model of developing countries rather than of transitional economies. These characteristics, she observes, "which have

underscored China's success are simply different than those faced by other developing countries." She opines that China's particular path makes it well positioned to pursue global markets and growth. "Comparisons should therefore be rooted in recognition of the particular stance of China rather than the laggardness of other countries, such as India," she adds.

David Wyss, Chief Economist, Standard & Poor's, New York, observes that China has been seen as more friendly to investment. However, he says that both India and China are unsafe in terms of intellectual property rights, although China is in a relatively better position to deal with such issues. Nonetheless he points to the factor of consistency in policies, which explains China's edge over India. He notes, "Chinese policy towards foreign investors is also more consistent. India has suffered from periods of encouraging foreigners, followed by periods of forcing them out."

Ashok Kumar, CEO, Lotus Strategic Consultants, Mumbai, India, too counters the notion of India's relative laggardness with reference to China. He opines that "If at all their (China) pace of economic reforms has been faster, it has something to do with the fact that they started earlier."

> **I feel that intra-industry trade will dominate bilateral commerce with the two countries often specializing in specific areas within the same industry.**
>
> **Sanjeev Sanyal**
> *Senior Economist*
> *Asia, Deutsche Bank AG*
> *Singapore*

China's Manufacturing Might – Misconceptions and Facts

- China's growth is driven only by an increase in investment, and not by improvements in productivity: Although gross fixed capital formation has been higher this has improved labor productivity more than raising employment. China achieved a productivity growth of 9% in the decade. Productivity there is 1.6 times that of India.
- Chinese manufacturing is driven primarily by exports: Domestic consumption in China is far higher than in India in many product categories. Its domestic market in CTVs is six times that of India's; its steel and cement market is five times larger.
- Subsidies, marginal pricing and faulty accounting drive prices low: Prices are low due to lower indirect taxes, lower import duties, higher labor productivity, lower capital costs and lower margins. Contrary to belief power costs are not much lower than those in India.
- China's exports have grown on the back of marginal pricing: Liberal FDI and world-class infrastructure enabling speedy shipment deliveries of exports have been the driver. FDI accounted for about 50% of the Chinese exports.
- Chinese goods are of poor quality: Competition and FDI has exposed Chinese companies to adopt best practices and thus raise quality standards.

Source: CII-McKinsey Report, "Learning from China to Unlock India's Manufacturing Potential."

Exuberating his confidence in the Indian manufacturing aspect he says, "The gap is narrowing and 10 years from now, I think India will be ahead of China on the economic sweepstakes."

Maybe, if the recent China rush by Indian companies are any indications, Indian manufacturers could well be on their way to create a niche of their own, maybe that would not necessarily mean competing directly with Chinese manufacturers. What is perhaps needed is the change in the mindset—from inward, looking just at domestic markets but at the global markets, particularly China. Perhaps, that is already happening. Indian corporates have begun to look at China as a market for their goods. China became the largest customer for mobiles in 2001, of steel in 2002 and, according to a report in *Newsweek*, the second largest buyer of personal computers this year.

The manufacturing lessons

India can learn a few important lessons from Chinese experience in economic reforms, which helped propel it to the top league in global manufacturing arena. India can look at China to understand and tackle issues like delegation of regulatory powers to the states in the matter of FDI (Foreign Direct Investment) approvals, a high level of flexibility in the labor market and low costs of raw materials. Another lesson India can draw from China is in the areas of development of Small and Medium Enterprises (SMEs) and stability in decision-making.

Experts opine that given the availability of low cost raw materials and cheap labor, China is all set to emerge as the world leader in the areas of light manufactures, electronics and appliances, besides strengthening its position in chemicals, leather and computer hardware. However, it might lose market share in agricultural and textile products.

Labor reform is one area where India can learn valuable lessons from China. There is a myth about low labor costs in China. However, the fact is that at an average of $1,000 per year or 38 cents per hour China's wage costs are comparable with those in India. What makes the difference, however, is the fact that labor costs in China are low as a percentage of the value of production as a result of high labor productivity

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and capital intensity. *BusinessWeek*, in its story titled 'India's China Challenge' (edition dated March 11, 2002) explains that "It's not that Chinese workers are always cheaper than their Indian counterparts. In fact, Chinese wages can be three times those of India's. However, due to China's passive labor unions, better infrastructure, and lower utility charges, even Indian companies with no interest in selling to China are making products there and selling them in India."

According to the findings of several research and consultancy firms and various Indian companies operating in China, substantial outlays on retraining of workers who lost jobs and the scope for dismissal of workers if found incompetent after retraining has imparted flexibility to the Chinese labor market and has offered an attraction for investors. Another interesting lesson can be the fact on how the Chinese Government deals with the issue of closure of its own industrial units. Experts say that while thousands of government sector enterprises were being closed in the past, several others were being allowed to be run by workers who had only to earn the variable costs and did not have to pay for the plants and other assets; while in the cases where management executives took over the enterprises, some amount of equity investment by them was insisted upon.

According to a study by Ernst & Young, half of the foreign investment in the manufacturing sector of China went into labor-intensive manufacturing such as food, textiles, furniture, toys and plastics. It says that one of the key cost advantages in China is domestic availability of petroleum products to the extent of 70% of demand (while in India's case it is reverse). However, according to the study, the single biggest advantage Chinese manufacturers enjoy is the feasibility of targeting domestic and export markets from one manufacturing base, ensuring economies of scale.

As far as having a global mindset is concerned, Indian companies have a lot to learn from Chinese companies such as Galanz and Haier, their significant focus on overseas markets (through exports and by establishing production bases in other countries) and the resulting success. The export mindset of these companies has translated into a large share of exports in total sales and large shares of key western markets. Haier, for instance, has been able to capture 30% of the US compact market within three years of its entry into the market. Hence, it would be desirable that Indian manufacturers take a leaf out of their Chinese counterparts and start looking at the world as their market instead of confining themselves to domestic markets alone. Perhaps that would mean a drastic change in thinking and big pocket also.

India Inc. – Tryst with China

Today, the breed of local manufacturers aiming to tap and exploit the opportunities in China is only growing. This new breed's strategy is twofold. At one level they're exploring opportunities to grab a slice in the burgeoning Chinese market pie. And, on the other hand, they're leveraging the Chinese market as a source for components and finished goods, so as to cut costs and gain competitiveness, both in Indian markets as well as abroad.

Consumer appliances maker Maharaja Appliances, for example, imports 20% of its components from China. The company attributes this to the fact that the imports from China are 50% cheaper when compared to India. Obviously this gives the company an edge over its rival products in the domestic market. Another company, which has reaped good benefits from its Chinese strategy, is Samtel India, the maker of picture tubes for

> **Instead of competing with China in manufacturing, we should establish ourselves in the services sector before China does.**
>
> **Saby Ganguly**
> *Founder*
> *Indiaonestop.com*

televisions. The company says that two years ago the local manufacturers were afraid that they would have to close their shops as the Chinese onslaught looked inevitable, however now they are learning to take them on successfully and also learn from them. China has proved a good opportunity for the Indian company. The ability to provide quality at lower prices has helped Samtel make a dent in the Chinese market. The Indian manufacturer has pursued a two-pronged strategy. On the one hand, it imports glass shells from China, while on the other it exports black-and-white television picture tubes to the country; China has a glass shell manufacturing capacity of 40 million annually with large-sized plants while prices are at least 4 to 5% compared to India. On the export side, the company offers reliable quality and also lower prices; it is 2 to 3% cheaper than Chinese manufacturers for its black and white picture tubes. The company says that the local black and white market in China is shrinking and it is able to offer good quality at cheaper prices. The company claims that this particular situation helps it squeeze the local manufacturers, many of whom are closing their shops.

The local auto industry too is now looking at China to flex its muscle, something that could mark a reversal to what they faced a few years ago. Already there are

talks about Indian auto industry players from the country aiming to outsource components from China so as to enhance their competitiveness both in domestic market as well as abroad. Recently, Bajaj Auto was identified by its Japanese partner Kawasaki Motors as its potential outsourcing hub to serve its global markets. If the domestic manufacturers like Bajaj Auto benefit from component imports from China and enhance their cost competitiveness, this could help them in a big way in setting their footprints on the global arena. Already JK Tyres, a major tyre company, has embarked on its China ambition. The company has tied up with a Chinese tyre manufacturer to produce LCV (Light Commercial Vehicles) and truck tyres, which are sold by the Indian company under its own brand name in several parts of the world. The company says that this has given it two advantages. One, sourcing these tyres from China has allowed the company to release capacity in its domestic plants that can be used for making radial tyres, thereby saving on fresh investment. Second, it's 20% cheaper to source tyres from China than in India, which adds to the Indian tyre maker's competitiveness in global markets. The company expects its global business to be worth around Rs. 800 cr in the next three years and half of that will come from China.

However, one industry that is being looked at as a sort of India's answer to China's hegemony in manufacturing is Hardware. According to a MAIT-E&Y study, by 2010, the Indian hardware industry has the potential to grow to 12 times its existing market size, with the domestic market accounting for $37 bn and exports accounting for another $37 bn.

The study has identified major export opportunities in the areas of new devices, contract manufacturing and design services. It says that component exports offer an opportunity worth $5 bn, while that of design and related services in embedded systems and wireless telecommunication services can bring in another $7 bn by 2010. Another segment where the study projects a rosy picture is contract manufacturing, which represents a $11 bn opportunity, provided India succeeds in capturing a share of only 2.2% of the global pie by 2010. The question that arises is—is this growth possible?

According to MAIT's President Vinay Deshpande, it is possible. According to him, there are four key steps which need to be taken to make India a manufacturing-friendly country. They are, firstly, market India as a hardware destination and build a brand akin to software. Making India manufacturing-friendly through improvements in infrastructure and logistics should follow this. He further says that India should also emphasize on design and innovation through the development of Indian solutions for Indian needs.

In fact on the design front, there are lots of opportunities left to be explored. Design exports are a $7 bn opportunity in areas like embedded systems and wireless telecommunications. While Indian firms do some work on hardware design exports, many unfortunately show this as software exports to avoid tax.

However, there remain some serious issues that need to be tackled in right earnest. According to etmachinist.com, a B2B magazine, concerns over the lack of local availability of input raw material, ever changing government policies, inconsistent sales tax structures in different states, high interest rates, customs duties on capital goods, poor infrastructure, inordinately long and variable transit times, they all add to uncertainty, delays and increased costs. These are the constraints, which the domestic hardware manufacturers have been coping for long. Industry experts say that the reason why, despite both the countries having similar duty structure, companies prefer to locate their manufacturing operations in China is that customs processing in China is much faster. They say that in India, even after a manufacturer's raw material arrives at a port it might take another month or so before the goods reach his factory. In the technology industry, where technological obsolescence rate is so high, such delays could cost companies dearly.

Another constraint hurting the growth of the manufacturing industry in India is the lack of proper environmental standards. With environmental concerns generally ignored or casually overlooked by Indian companies, foreign companies desist from setting up manufacturing bases here since there is no compliance

India Inc. – Strategies for Dealing with the Dragon

- Try to catch up with China to grow exports in labor-intensive industries such as, apparel, footwear etc., by increasing export targets, benchmarking labor productivity to world-class levels and developing market capabilities.
- Build IT-like dominance in skill-intensive industries such as automotive, pesticides, pharmaceuticals etc., and grow exports in these sectors.
- Grow exports, also to China, in areas such as steel and aluminum, which depend on raw materials that India has in abundance.
- Evaluate whether or not to source from China in capital-intensive industries. For example, plastic products, organic chemicals, polymers, where only a few Indian players who are able to set up projects at low capital can win.

Source: CII-McKinsey Report, "Learning from China to Unlock India's Manufacturing Potential."

with ISO 14000 standards, which deal with environmental issues.

In fact, the Indian hardware industry could learn a thing or two from the Taiwanese hardware industry, where companies started off as component assemblers few years ago. Today, the same firms are world leaders, and, in fact outsource their manufacturing designs to other countries. A majority of Taiwanese firms are now original manufacturers of chipsets.

Dr. Linda is bullish about the Indian Prime Minister's recent visit to China. She says, "It seems to be a new era of cooperation and coordination. The Border Trade Agreement and the re-opening of the Nathu La pass in Sikkim are notable advancements in bilateral relations. What holds most hope for the future of the two economies is the anticipated coordination in the WTO. The upcoming Doha Round in September will witness the banding together of developing countries. The success of these countries in negotiating for agricultural liberalization in developed countries and other issues concerning pharmaceuticals have a greater chance of success if led by China and India. These issues will undoubtedly benefit the Chinese and Indian economies. They should complement each other. Through comparative advantage, the countries can take advantage of each other's existing strengths and together they stand a greater chance of eliciting the removal of barriers to free trade currently imposed by some developed countries."

Dr. Linda opines, "Indian companies will face many of the same issues experienced by US and European corporations. The most important ones will concern negotiating the incomplete legal system and the inconsistent system of enforcement of trade and investment agreements. The use of local resources, such as consultants, lawyers, and other experts will be the key. Finally, language will be a barrier as it has been for many other companies. English is not the operating language of China, unlike Hong Kong, for instance."

Echoed by Sanjeev Sanyal, "MNCs that have used China as an export base make money but those entering the domestic market have a difficult time. China's domestic markets are growing but they are not easy to enter profitably. There are many problems from overcapacity to intellectual property rights. Indian companies entering China must be sure about their long-term competitive strength because local entrepreneurs will clearly have a home advantage." He further adds, "I think Indian manufacturing has dramatically transformed itself over the last two years and in many areas is now prepared for the world (including China)—for details see my report 'Will India Challenge China' (Deutsche Bank Research, December 2002). However, there are many areas that still lag but, in my view, the problem is largely our unwillingness to allow our best entrepreneurs to scale up. Small-scale sector reservations need to be removed as soon as possible in order to allow restructuring of remaining sectors. Some inefficient companies will shutdown but that is a cost we must be prepared to pay as society."

Riding the dragon – Is India Inc. ready?

Nonetheless India Inc. seems to be ready to bet on China, as it turns to the world's largest market for growth. However, this raises some concerns as well. To quote *BusinessWeek*, "While the stampede into China has clear benefits for a range of Indian companies, the potential impact on the domestic economy is mixed. Certainly, the threat of China is already transforming labor relations in India as workers find it harder to demand raises. Moreover, Indian managers are waking up to the need for change." Though it would help in ensuring cost competitiveness of Indian companies, it would also mean a battle of survival for many. And, it is likely that the bloodbath would have just a few survivors.

"If the regulatory and economic barriers were meaningfully addressed, India would have a better shot at emulating China's success in manufacturing."

Devi Aurora
Associate Director
Global Fixed Income Research
Standard & Poor's, New York, US

Notwithstanding such concerns, going by etmachinist.com suggestions, India's task of matching the efforts of Chinese companies and boosting its own exports is daunting but doable. To emerge successful, even under the current policy regime, Indian companies need to adopt a new mindset and reshape their strategies to achieve aggressive domestic and international growth. To achieve the above two main steps need to be taken. First, Indian companies need to grow the domestic market through lower price-points. This will require significant productivity improvements, re-engineering products, sourcing from China (if relevant), design of new products and improved marketing effectiveness. Second, Indian companies need to acknowledge the world, including China, and not just India, as their market. However, the big question remains—Whether Indian corporates can turn China's threat into a lasting change.

Amit Singh Sisodiya and N Janardhan Rao

Reference # 1-2003-08-04

INTERVIEW

"China is not a place where any foreign investor has made significant profits, partly because the rules of competition are changing constantly"

says Prasenjit K Basu, Managing Director, Robust Economic Analysis (P) Ltd.

O On India's relative laggardness vis-à-vis China?

I am not happy with your characterization of India's 'relative laggardness'. For the past 20 years, India had the fastest-growing economy among the democracies of the world with a population of over 5 million (Botswana is the only democracy that has grown faster, but its population is less than 3 million). This is no mean achievement, although autocracies naturally can generate faster growth by suppressing political freedom. That itself is one explanation for the slightly faster growth rate that China has achieved in the past decade (averaging about 6.5-7%, after taking out exaggerations in the reported data) than India (about 6%).

I would point to three other key factors that explain the difference. First, in Hong Kong and Taiwan, China effectively had access to two of the great success stories of global capitalism — one of its leading financial centers, and a key outpost of technology-investment, respectively — that are the key sources of FDI inflows into China. (China's own figures show that about two-thirds of its FDI come from Hong Kong and Taiwan; and by its definition, both Hong Kong and Taiwan are part of China, so this isn't really Foreign Direct Investment (FDI) at all). Hong Kong (an island to which China's capitalists and entrepreneurs had fled after the Communist revolution, and helped to develop into a haven of free-market success) was told in 1984 that its destiny was to be forever tied to China, obliging its businessmen to begin investing in China (and Deng Xiaoping's reforms that year—including the establishment of SEZs—were aimed specifically at tapping into this source of investment).

Second, China's reforms started sooner (with agrarian reform in 1978-79, and the great opening to FDI via the SEZs in 1984) than India's (in 1991 under Narasimha Rao and Manmohan Singh). This has helped give China gain a lead in virtually all social indicators and in the size of its middle class.

Third, China has been far more accommodating toward FDI (especially from its own diaspora, not only in 'Greater China' but from all over the world) than India has been. This is partly explained by the fact that India has its own domestic entrepreneurial sector, while China has no successful domestic private enterprises of any significant size. China's dynamic export sector is dominated by foreign invested firms, and the local enterprise sector remains very weak; when another competitor economy emerges with even lower wages than China, FDI will be apt to move there (possibly even India, if the labor reforms are passed within the next 3-5 years). In India, however, the dynamic export-oriented sectors (software, business process outsourcing, pharmaceuticals, aluminum, steel, specialist yarns, engineering goods, automobile components, gems and jewelry) are all dominated by Indian firms. This is a tougher route—that may appear slower in the near-term than the foreigner-dominated approaches of China and South-East Asia—but it is the route that is likely to prove more durable and successful in the longer-term, as indeed it was for Japan, Korea and Taiwan.

O On Indian Prime Minister's visit to China.

It is eminently sensible for the world's two largest countries (by population) to cooperate (especially on issues relating to global trade and other developing-country issues). But I believe the specific agreements on border trade will have a very limited impact—apart from providing a mild fillip to Sikkim, and boosting the importance of Siliguri as an economic center. In my view, PM Vajpayee's visit was an enormous success for China's long-term strategy with respect to India, while yielding nothing of substance for India.

The over-riding issue in relations between India and China remains the fact that China is attempting to strategically strangle India, with a Listening port in Burma's Coco Islands, a port in Baluchistan (Gwadar) being developed as effectively a Chinese naval base, a Maoist insurgency in Nepal (plus a king, Gyanendra, noted for his pro-China stance in distinct contrast to his predecessors) and a Bangladesh (BNP-led) regime that is strongly pro-China too. India's responses—naval exercises with Vietnam, gingerly steps toward friendship with Japan and US—remain feeble at best. Not many people in India have heard about former Taiwan President Lee Teng-hui's suggestion of a Taiwan-Japan-India alliance (economic and political) to counter communist China. This is an idea whose logic is self-evident and would have enormous economic potential, as Japan and Taiwan have been the two largest investors in China's manufacturing sector.

Until India's strategic thinkers begin to recognize these realities, they will be condemned to repeat the mistakes of their predecessors. Just as Zhou en-lai promised Nehru he would amend the maps in the future (to reflect the 17-point agreement he had come to with Nehru), so Wen Jiabao now promises to amend maps in future to reflect the fact that Sikkim is part of India (and what about Arunachal Pradesh?).

China's invasion of Tibet in 1950 is a much bigger 'legacy of history' than India's annexation of Sikkim (which, as a Hindu and Buddhist land, is

civilizationally part of India rather than China; all across Asia, Buddhism is seen as the continent's link to India). China argues that the McMahon Line is illegitimate because it was signed by Tibet and British India (both regimes that were illegitimate in China's eyes); but India must argue that the Qing dynasty (which established China's claim on Tibet, and was in its last throes when the McMahon Line was drawn) was also illegitimate in China's eyes (as the Manchu Qings were not considered Han Chinese at all—and did not consider themselves so either). It is folly for any Indian leader to give up an iota of India's bargaining power over Tibet without gaining something in return. If China's suzerainty over Tibet is given historic legitimacy, it is a small leap before Arunachal Pradesh, Sikkim, Ladakh, Bhutan—even Nepal—and the whole North-east of India begin to come under China's civilizational claims. These are not trivial matters, as 1962 should have taught us—a war China fought despite being in the throes of a famine of unimaginable proportions in which 30 million people had died in 1960-63 in the wake of the failed Great Leap Forward of 1957-60.

O On the practical difficulties in tapping the dragon land.

China is not a place where any foreign investor has made significant profits, partly because the rules of competition are changing constantly. But there are specific labor-intensive manufacturing sectors in which China is super-competitive (textiles, garments, shoes, toys etc.). Indian businesses that do not already have a presence in China need to be very careful and selective before making a foray into this market. Indian corporates need to be particularly careful about guarding their intellectual property rights in China.

Careful study and safeguards can, however, yield spectacular results—as long as the main purpose is to manufacture in China for export to the world. Enormous patience (of the sort displayed by the Japanese and Koreans) and deep pockets are necessary to really penetrate the Chinese domestic market (just as foreign investors like Kellogg, Coca-Cola etc., have found in India, as opposed to the longer-term players in India like Unilever, Nestlé, Citibank, Siemens, GE etc.).

O On India's ability to replicate China's success in manufacturing.

India can replicate China's manufacturing success, but there are two things India needs to do. First, reform labor laws to make it easier to layoff workers (while also assuring that the laid-off are properly compensated) thereby ensuring a more labor-intensive development path. Second, encourage investment in India by the vast diaspora: When L N Mittal (whose global steel empire is run largely by veterans of SAIL) feels it worthwhile to buy part or all of SAIL, or the Hindujas, Lalvanis, Swaraj Pauls, Harilelas, Chandarias, etc., of the world begin to make India their favored investment destination (as the whole world's Chinese have done in China), India's manufacturing revolution will truly take off. That is, of course, not to say that manufacturing isn't already doing well: Ranbaxy, Dr. Reddy's, Moser Baer, Bharat Forge, Hindalco, TELCO etc., are all proving India's manufacturing prowess without giving up Indian control over their enterprises.

Enormous patience and deep pockets are necessary to really penetrate the Chinese domestic market

O On collaboration between India and China.

There are some complementarities at present. India is good at 'software', broadly defined to include the creative arts and entrepreneurial skills. China is good at hardware, including the ability to build quality physical infrastructure—but, via Hong Kong, has been able to reduce its software deficit. And India is good at knowledge-intensive tasks (because of its vastly-larger pool of graduates in engineering, medicine, accountancy etc.) while China is far better at labor-intensive tasks (especially manufacturing labor-intensive products). These complementarities offer opportunities for cooperation. But there will always be competition: Just as India should not abdicate the labor-intensive manufacturing space, so China cannot be expected to passively allow India to retain its lead in knowledge-intensive areas.

O On other issues.

Since 1962, India has had an inferiority complex with respect to China, which was the precise purpose of Mao's October 1962 invasion. There are enormous strengths India has, including the predictability of political change, a fair (albeit creaky) judicial system, relative security of contract etc., that will stand India in good stead over the long-term.

China has built enormous financial bubbles that are bound to burst in the next 5-10 years, and has a very fragile financial system. But aided by inflows of capital, technology and software from Taiwan and Hong Kong, China already has twice the per capita income of India. This means that India cannot allow China to continue outperforming it economically for any 5-year period without the gap between the two widening even more. India's elites need to be alive to the danger emanating from China's economic advance and strategic stranglehold over India's neighborhood—and come up with creative ways of overcoming these handicaps through political alliances with friendly democratic countries, and those (such as Japan, Taiwan, Vietnam, Tibet, Korea) who are currently in China's embrace but remain ever-cognizant of its long-term threat to their future. That India and China are now engaging each other seriously is a positive thing (as India was among the few of China's traditional 'adversaries'—south Korea, Taiwan, Vietnam, Indonesia, Japan, the US—who had not successfully engaged it). But India must learn to dance with China while ensuring it is not strangled by it in the process.

INDIA INC. VS. CHINA

Closing the gap

In order to achieve faster rates of economic growth, India needs to strengthen its own manufacturing sector and also create adequate number of jobs to absorb the large increase in workforce expected by 2012, says Dr. Sudipa Majumdar, Proprietor, Newel Consultants.

In 2000, the Asian Development Bank (ADB) reported in its annual economic outlook that the Indian economy was set to surpass China. This optimism was mainly due to the new economy boom in the form of the software industry and services sector. However, it soon became clear that China was far ahead of India in terms of all direct comparisons and it would take India more than two decades to catch up with China.

A comparison

India and China were very similar when India attained its Independence in 1947 and the Communists assumed power in China in 1949. At that time, factories in both countries were devoted to production of light consumer articles, particularly textiles, and a large portion of industrial production was from cottage and handicraft industries. Both countries began their development programs in 1952. In the period 1952-80, both the countries grew at about the same Gross Domestic Product (GDP) rate and the per capita income in 1980 was also approximately at the same level.

Under the leadership of Deng Xiaoping, China initiated economic reforms and its economy grew at double the rate of India during the 1980s, widening the gap considerably. After a decade, India launched its industrial reform in 1990 and began its acceleration and has been slowly catching up with China. The headstart that China had in economic growth in the 1980s stood in good stead. The per capita income was about the same in 1980 while evaluated in PPP terms, the gap was 60% in favor of China in 2000, according to a McKinsey report. The huge difference in per capita income with two decades was due to a higher growth rate of GDP along with a lower growth rate of population. China also experienced a much higher rate of gross domestic investment, which has been more than twice the rate in India over the 1990s.

China has had an impressive growth in exports and at the present levels China's export is almost five times that of India. Chinese export of services is almost three times that of Indian exports of services and import of services is almost equally large. China also has a huge positive current account balance as compared to the deficits that India has been witnessing over many decades. Consequently, China's international reserves are also nearly five times that of India's.

China's economic growth has been mainly pushed up by huge Foreign Direct Investments (FDIs) into the country, which was far ahead of the experience in India. However, a direct comparison may be erroneous—it has been brought to light that China's figures are inflated by 'round-tripping' or recycling of domestic investment through Hong Kong while at the same time, India's figures are understated since they exclude foreigners' reinvested profits, the proceeds of foreign stock market listings, intra-company loans, trade credits, financial leases etc. Even if a direct comparison of the figures may be incorrect, we can still see that more than 75% of China's FDIs went into the setting up of new green field projects, while in India 65% of the FDIs went towards mergers and acquisitions of existing enterprises. Of the remaining 35%, the investments in India were concentrated in quick-yielding consumer durable sectors and none of them went for infrastructure developments like power or other critical areas such as railways, airlines, highways and telecommunications.

Shortage of power in India is estimated at about 10% of total electrical energy. Many rural areas are still without electricity. India's per capita electricity consumption is very low at 270 kilowatt hours/year as compared to 480 in China. In contrast to India's neglect of the basic infrastructure, China is investing its surplus in railroad, power, road and water management in a concerted way and has brought about considerable improvements in the basic infrastructure of the country.

Even in terms of human development index, China is ranked far ahead of India. China's literacy rate is almost 1.5 times that of India while the infant mortality rate is less than half of India's. Public expenditure on health in China as a ratio of GDP is three times more than India.

China's success can be attributed to the creation of world-class infrastructure, installing adequate power generating capacity, extending preferential policies for FDI and instituting a firm friendly labor policy. The sequencing of reforms also has been a critical factor in China's economic success.

Closing the gap

There is today a substantial gap between China and India. However, the target is surely within reach. India needs to concentrate on an accelerated growth in agriculture, information technology, services and exports during the next two decades. India's industrial output growth rose to 5.8% in 2002-03 as consumers spent more, up from a meager 2.7% last year when a global and domestic slowdown hit demand. The strong industrial output and good agricultural production could help India's efforts to keep up with China, whose GDP grew 8% last year. However, India needs to make special efforts fiscally, to raise the rate of investment to reach or cross 30% of GDP, along with the GDP growth rate of 10% annually.

In order to achieve faster rates of economic growth, India needs to strengthen its own manufacturing sector and also create adequate number of jobs to absorb the large increase in workforce expected by 2012. Otherwise, the manufacturing sector could decline further. A major problem in India has been the high levels of excise and import duties on machinery, while machinery is duty-free in most South-East Asian countries. This makes Indian goods incompetent due to high costs. Therefore, India can make a big difference in the global scenario through low or zero duties on industrial inputs and capital goods, reasonable prices for power and capital and better infrastructure.

The bridging of the China-India gap looks more achievable when we take a closer look at China. The characteristic feature of the Chinese economic strategy had been to create separate channels for development outside the State sector, by emphasizing on market forces and phasing out Central planning. However, several studies are now pointing out that although this process (which has been termed 'growing out of the plan') has been highly successful, its ability to push China's economic development further is coming to an end.

There have been structural problems in the real economy of China, leading to growing underutilization of labor and a gradual slowdown in real growth over the 1990s. China's average tariff rate has fallen from above 40% in the early 1990s to 15% in 2001. In spite of the huge FDIs, China's economy has been operating below its productive potential. The studies point out that human capital, land and other resources are underemployed, misallocated among economic sectors and inefficiently used. This has been due to internal barriers to mobility in factor and product markets. There is total lack of integration among Chinese regions, and between rural and urban areas.

There have been structural problems in the real economy of China, leading to growing underutilization of labor and a gradual slowdown in real growth over the 1990s

Once the shortfalls of the Chinese economy come to light, the challenge of India catching up with China does not hold its charm any more. In fact, it seems more logical and interesting to find synergies in the two countries, so that both can take advantage of their complementaries.

China and India – Competitors or partners

China is a manufacturing powerhouse, while India is a knowledge-driven power where services account for half its economy. China has a strong hardware base while India boasts of its software. The two countries have realized their complementaries and the latest by-word is that India and China should be "partners rather than competitors". Synergies could well develop between the two nations and this could be a win-win situation.

The feeling is especially strong in the information technology sector where the companies feel that India should leverage China as a strong partner and build linkages with Chinese companies since China has been successful in low value, high volume technology business while India has advantage in high value, low volume business. China is very strong in hardware and the companies have a requirement for domain expertise as well as project management skills, which can be supplied by Indian companies.

On the trade front, the bilateral relations between the two countries have witnessed great improvements. While India's imports from China grew by 39% to $1.99 bn, our exports to China rose by a whopping 85% to $1.2 bn in 2002-03. A closer look, however, reveals that India has been exporting iron ore and primary, semi-finished iron and steel and marine products. In contrast, electronic goods, organic chemicals, pharmaceutical products are the main imports from China. There has been a recent agreement between the Governments to step up border trade between the two countries through Sikkim, which would boost trade figures significantly. The architecturally South-North pattern of trade is also expected to change with closer cooperation and better trade relations.

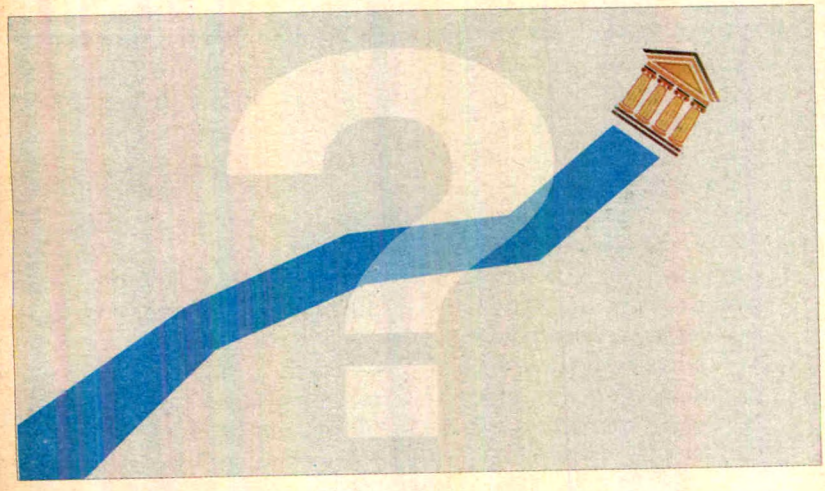
The recent visit of the Prime Minister to China is expected to be a move in the right direction and the talks of partnerships and stronger bilateral relations have been encouraging. One hopes that the intentions would be supported by adequate policy measures, positive fiscal incentives and strong political motivations to take this forward and make it a success.

Reference # 1-2003-08-05

BANKING STOCKS

Is the party over?

Indian bourses have rediscovered the banking company stocks. What are the reasons behind this?



Investors in India witnessed banking stocks, especially the public sector banks taking the top honors in the first half of 2003. Those who invested in Oriental Bank of Commerce and Punjab National Bank saw their wealth appreciate by as much as 200% and 223% within a year. For most part of 2001 and 2002, banking stocks were lying low except for few rallies that couldn't sustain. A host of problems were plaguing the banking sector of which the most worrying factor being huge NPAs. But in the year 2003, it has been a party time for the banking stocks, with the exception of ICICI Bank, IDBI Bank and HDFC Bank. Over a period of one year, ICICI Bank stock had depreciated by 1.6%, IDBI Bank lost its stock value by 19.6% and HDFC stock was appreciated by a mere 13.8%. Compared to other PSU banks, this growth is very minimal (see Table 1).

The latest rally is fueled by various factors. This can be attributed to a combination of structural factors such as debt-buy-back and return of capital and liquidity—with funds chasing stocks from this sector. The PSU banks have been the biggest beneficiary of the developments in the banking sector. These banks have also benefitted from the upgradation of technology, which seem to have improved efficiencies further. For example, implementation of technology has helped them lower their transaction costs due to networking advantages. Also, employee rationalization measures (e.g., VRS) undertaken by banks have helped them bring down costs further.

NPAs: No problem assets?

The passage of the 'Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002' by the Indian Government gave a new life for the troubled banking companies. This law allows banks to takeover the assets of the defaulters and give power to either dispose them off or transfer them to an asset reconstruction company for recovery of dues. As on March 2001, net NPAs at Rs. 64,000 cr, accounted for 11.8% of the advances in the banking sector. Although there are alternatives available for banks to recover their NPAs, the Securitization Act is expected to help them a lot in recovering their dues. News reports suggest that many banks have already issued defaulters with notices to the tune of several thousand crores, which have brought many of them to the negotiating table. Banking experts expect a good amount of NPAs to be recovered in the next three years.

Low interest regime

In the last few years, India witnessed a consistent fall in interest rates, which in turn boosted banks' bottom lines. The low interest regime saw a surge in demand for retail loans. Subsequently, most of the banks, if not all, shifted their focus to retail sector. For banks, interest income from advances is their bread and butter. A falling interest rate scenario has helped Indian banks in two ways. First, banks have significantly improved their Net Interest Margins (NIMs). Second, they were able to book profits on their G-Sec portfolios.

Banks in general reprice their liabilities faster than their assets. Thus, they can improve their NIMs. How does this work? With falling interest rates banks lower their deposit rates faster than their lending rates. This will improve their interest spreads and consequently better NIMs. But as interest rates are not expected to fall drastically as seen before, banks will not be in a position to significantly reduce their deposit rates like they did earlier. Banks are also likely to face increasing pressure on the yields front. As lending rates are also falling, the interest spread that a bank makes will also fall from here on.

Another worrisome factor is that the yields of banks from their G-Sec portfolios are likely to fall much faster. Falling interest rates imply that new G-Secs issued in the markets will have lower yields.

Hence a bank's incremental investments will yield lower returns. Second, in order to take advantage of the falling interest rates, banks have aggressively sold off their G-Secs. Consequently, the fall in returns from G-Sec portfolios of banks will be much faster.

The Indian retail segment, which has majorly boosted credit growth in the country, has become more demanding and hence banks are under increasing pressure to structure the price of their products in line with customers' needs. Banks have enjoyed the benefits of falling interest rates in the past but increasingly benefits of this scenario are likely to diminish. From here on, banks with a reasonably large presence and who have the ability to garner low cost deposits will be the entities that would be able to maintain or at least limit the fall in their NIMs. As the pressure on banks increases only the ones with a strong focus for the long-term and integrity will be successful.

The government tangle

Another important factor for the rally in the banking stocks has been the proposal by many banks to return capital to the government, which essentially means that the government holding in these banks is going to reduce. While Bank of India has already returned Rs. 150 cr, other banks like Andhra Bank, Punjab National Bank and Oriental Bank of Commerce have proposed to return some portion of the capital to the government. The return of capital has a twofold effect on a stock's valuations. Due to return of capital the government's stake reduces, indicating that the government interference in the management of the bank will lessen. PSU banks seem to have no continuity in the policies initiated by different managements. The reduction of the government's stake in these banks will automatically lead to better perception regarding PSU banks. The second positive effect of this activity is that when capital is returned, there is a reduction in the number of shares outstanding and therefore an automatic improvement in earnings per share. Thus, valuations will automatically improve.

Bank Stocks Performance

	% gains over 1 year	P/E	P/BV
Private banks			
HDFC Bank	13.8	18.1	3.1
IDBI Bank	-19.6	5.1	1.3
ICICI Bank	-1.6	7.2	1.9
UTI Bank	26.8	6.0	1.5
PSU banks			
BOB	75.3	4.3	0.8*
BOI	45.5	2.9	2.2
Corp. Bank	44.9	5.7	1.0
OBC	200.0	5.8	1.4
PNB	223.7	4.9	1.1*
SBI	47.9	6.1	1.1

* Not adjusted for NPAs

Source: www.equitymaster.com

"Most banks have done well piggyback riding on treasury income and not from income from banking operations (which actually the banks are meant for)"

Prof. Debajyothi Ghosh Roy, Director, BDP Consultants

O On the rise in the prices of banking stocks.

It can safely be said as mostly speculation than due to strong fundamentals. It is a fact that almost all banks, including the not so well performing public sector banks, have done well in the year 2002-03. However, a closer look will reveal that most banks have done well piggyback riding on treasury income and not from income from banking operations (which actually the banks are meant for).

O On low interest rate phenomenon.

The interest rates are likely to go down further in three to five-year time-frame. The cost of funds of the banks are likely to go down further, with interest rates falling in the future above time-frame. Hence, even if there is commensurate fall in lending rates, the net interest margin will remain at today's level or may even improve. In that case (if NPAs keep on going down), the banks may show even higher profits from banking operations (which presently they are not showing).

O On RBI guidelines on compliance with accounting standards by banks.

In the short to immediate term the impact will be negative in case of most banks. However, there will be enough scope for financial engineering to ultimately show a reduced impact on the bottom line. It will be interesting to read the balance sheets of banks post 2004 March onwards.

Outlook

Recently the Reserve Bank of India issued guidelines on compliance of accounting standards by banks. Banking experts feel that this can have a negative impact on the balance sheets of the banks in future.

Now, coming to the valuation of the banking companies, most of the PSU banks are lagging behind their private sector peers. Except for HDFC Bank, which trades at a premium both in terms of P/E and price to book value, all other banks are more or less trading at similar P/E ratios. Does this mean that the market has taken into consideration all the good news? In the long-term the future prospects look good for the banking sector for it has immense potential for growth in terms of new business opportunities. However, only those banks with clean balance sheets and a penchant for growth can see a substantial increase in their shareholder wealth.

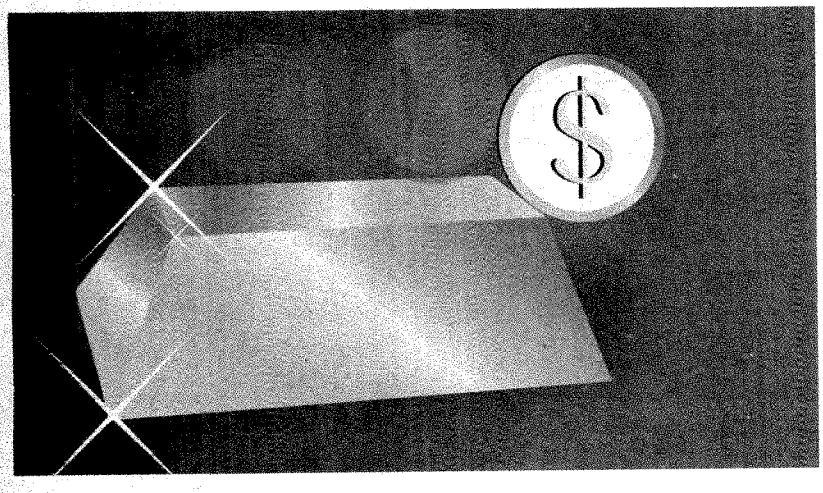
Shashidhar Mishra

Reference # 1-2003-08-06

GOLD VS. DOLLAR

Changing equations

The incredible debt of US Government, plummeting interest rates and sliding dollar offer the recipe for the yellow metal to become bullish. Will the honeymoon last?



In many ways, the price determinants of gold differ from those that influence most other financial assets. The glitter of gold in the recent past was driven by uncertainty in gulf region and now the continued depreciation of US dollar against the euro and yen. The dollar has floated near four-year lows against these currencies. The weak dollar has been the dominant cause of the yellow metals' rise and is having a positive impact on the demand from industrial users. It encourages investors to increase long positions because the price for buyers in non-dollar areas is witnessing a fall. Gold is an elegant alternative to the dollar. It has an inverse relationship with the dollar and the stock market.

A weaker dollar stimulates buying of dollar-dominated gold by making it cheaper for foreigners, while falling stock prices raise gold's safe haven status.Yet, most factors affecting the price of the yellow metal have remained bullish, or in some cases become even more so. During 2002, the yellow metal gained about 25.4%. This is the highest year-on-year increase in gold prices in the past 20 years. It outpaced the stock market, bond market and every major industrialized currency in the world. During the fiscal, the bullion has appreciated almost 6%. In fact, its fundamentals continue to improve almost on a daily basis. The main reason is that it's no longer in the interest of the central bankers in the world.

Unlike in the past, they are expected to be buyers and sellers of gold. Not only is the supply of gold constrained because of the Washington Agreement, but also central bankers appear to be curtailing their activity because of concerns over the weakness of the dollar. The European central banks support a low dollar-gold price. Gold experts say that its current bull market is different from any other in the past. Alex Wallenwein Editor, Publisher, *Euro vs. Dollar Currency War Monitor* believes that the euro will take a center stage again after the US bear rally in stocks runs its course, driving the dollar lower. In addition, the unsustainable US current account deficit will do its own to force dollar values lower. As all other investment vehicles fail or fail to perform compared to gold, investment interest from the 'street' will slowly wake up and probably climb slowly.

The favorable environs

The waning stock markets, falling interest rates and global tensions and deregulation of the Chinese gold market have created a favorable environment for the yellow metal. Besides, the recent developments on US front, like the budget surplus has turned into an enormous deficit, and there is a debt problem at all levels—from consumers to corporates and the government in particular. In short, the emerging global environment is characterized by the significant risks to the value of money on account of the deflation threat, which is helping gold get its glitter back.

As the dollar's weakness continues, the currency trade is beginning to take hold in the gold market. Countries, particularly from East, continue to shift their currency reserves out of the dollar and invest a part of that into gold. In Russia, the Deputy Finance Minister announced recently that dollar reserves should be cut from 70 to 50% and gold reserves more than doubled to 10%. China's intention to move its currency upwards would lead to a diversification in foreign currency reserves.

The Dragon, world's third largest consumer, is diversifying its bullions by buying euros and gold instead of dollar. Opines a gold analyst, gold has probably seen its lows and is set to steadily rebuild and move to higher levels.

There is no asset compared to gold, which has enjoyed widespread acceptance as a medium of exchange and store of value. Because gold is the ultimate currency and moves opposite to the dollar, some economists argue that the world is on a *de facto* dollar standard, akin to the 19th century gold standard.

Gold vs. US Economy

Iraq's switch over to euro-backed oil payments before the US invasion, North Korea and Iran's plan to trade in euro and the EU's challenges to US, all these dramatic changes look like as if the world is too small for the dollar to grow. At last for the first time since Bretton Woods, the dollar now had a competitor: The euro, a currency that has a positive relationship to the price of gold. It's a single currency of a combined market that is actually bigger in population size than the US. Alex Wallenwein observes, "The euro vs. dollar war is the most recent and most defining chapter in gold's 5,000 year history. Unlike US, the EU countries mark their gold reserves 'to market'. These countries value their gold reserves at gold's market value, which in turn means that the euro's value goes up when the price of gold rises. And the price of gold is rising, not least of all because the euro countries' central banks have agreed to limit their gold sales and gold leasing activities. Given this background, the gold works as a secret weapon to the EU.

US intention of keeping the price of gold under control is to prevent too many dollar holders to sell dollars and buy gold during inflationary times

US is dead-set against rising gold price, and it would undermine Americans' and the world's confidence in the dollar. US intention of keeping the price of gold under control is to prevent too many dollar holders to sell dollars and buy gold during inflationary times.

If the US economy does not improve in near future, then the Fed will be forced to continue to use extraordinary measures, along with the fear of deflation, which will cause the price of yellow metal to rise as dollar falls. Economists say that in the long run, the enormous budget deficit, trade deficit and current account deficit will cause the dollar to decline further. In addition, the easing of monetary policy and aggressive inflationary policies by the Fed should also support gold and lead to a lower dollar.

Says Alex Wallenwein, "in US, the dollar is stuck in a rat race against the price of gold. When gold rises, people in America think it's 'inflation time' and they pull in their consumer horns—which is bad for the economy, and that makes it bad for the dollar's foreign exchange value. Americans buy less stuff, and foreigners buy less American stuff (stocks, bonds etc.), and the foundation of the house of cards starts getting a bit shaky.

He further adds, in the currency war, the euro is set to 'benefit' from a rising market price of gold, while the dollar would lose credibility as gold climbs." Without EU system support for lower gold prices, they will gradually tend higher; making it impossible for the dollar to sustain its buying power, which in turn will contribute to dollar flight into either euro or gold. Both cases are bullish for gold. It will become the No. 1 measure of true wealth again. The euro system banks have signaled that they no longer support a low dollar gold price as a world monetary necessity. As gold sales and eventually leasing from European central banks dries up, it will become more and more difficult for US to shoulder the burden of a controlled gold price. Eventually, even the US Government/Fed will run out of ammunition the bullion banks may no longer find it worthwhile to borrow and short gold.

"The Euro vs. Dollar war is the most recent and most defining chapter in gold's 5,000 year history. Unlike the US, the EU countries mark their gold reserves 'to market'."

Alex Wallenwein
Editor, Publisher, Euro vs. Dollar Currency War Monitor

Gold vs. Currency devaluation

At the Bretton Woods Conference in July 1944, international leaders sought to insure a stable post-war international economic environment by creating a fixed exchange rate system. US played a leading role in the new arrangement, with the value of other currencies fixed in relation to the dollar and the value of the dollar fixed in terms of gold—$35 an ounce. Since then gold was the pivot of the world exchange system. Gold never changes, it has no nationality and is eternally and universally accepted as the unalterable fiduciary value par excellence. The bullion is a good hedge against depreciation in value of money. During the last two years the global economy has been witnessing a sluggish economic growth.

The growth virtually stalled. Experts say that there is a historical precedent for this currency event in the 1930s and it was positive for gold. The present massive investment and consumption boom has created an environment of excess capacity, which is fueling fears of deflation.

"In rupee terms gold has been at record levels, partly because of the movements between the dollar and rupee."

Rhona O'Connell, Market Analyst, World Gold Council, London

Q In the current market scenario, what is driving the gold prices?

As we move into the northern hemisphere summer, the physical market for gold tends to slow down because of the holiday season in US, Europe and parts of Asia, and also the monsoon season in India, which of course puts the brakes on physical demand in India during June and July. For the longer term, physical demand is reasonably robust and helping to keep a floor under dollar gold prices, as is the fact that some miners are delivering into hedges. This means that metal that had previously been sold forward by miners is now being delivered against those contracts and therefore not all the newly-mined metal that is being produced is coming into the physical market.

These factors are enough to support the price, but not necessarily to drive it higher. For that to develop, the market needs also to see increased investor interest, and this is what we have seen over the course of 2002 and the early part of 2003. The investors who have come into the market (or in some cases, who have returned to it) are those who are looking to diversify against risk. There have been increased risk elements over the past 18 months in the currencies, the equity markets and parts of the world's banking system. Corporate governance was a big concern as well, but appears, at least, to have abated (for the time being), and of course geo-political risk remains an element. There are also growing concerns that the three-year bull run in bonds is now drawing to a close.

Of all these factors, probably the key to the moment is the trend in the dollar. This is not just because gold is denominated in dollars, but because a wide range of market concerns are encapsulated in the currencies. While the dollar has recently shown some signs of strength, there are fears that the US economy is not recovering as well as could be wished and also that the deficit is becoming too large to manage easily. This means that the overall view on the

The price of any physical commodity will rise if the currency becomes worthless. In such a scenario, gold as a class of money is likely to outperform all other forms of money. It would emerge as a safe method of storage value.

It's different this time

The current bull market for gold is different from any other in the past. It pushed the price above $350 an ounce for the first time in March 11, 2003. According to a London-based consultancy Gold Fields Mineral Services Ltd. (GFMS), the price of gold will rise as high as $370 by the end of 2003. GFMS Managing Director Philip Klapwijk, unveiling the 2003 Gold Survey, says that the post-war economy would favor gold as a safe haven due to expected low interest rates and a continued sluggish stock market.

Once the US stops its anti-gold stance and marks its gold reserves 'to market' as the euro does, there will no longer be an official reason to suppress gold

Alex Wallenwein is bullish about the present rally of gold prices. He opines, "The present rally could be unique in that I do not see the price of gold returning 'to earth' after it takes off. Gold will never—by market forces—come down to where it is today as a result of the tremendous amount of inflation in paper-gold substitutes. Those substitutes will lose credibility as the shortage in physical relative to the supply in paper claims becomes apparent—at least at anywhere near current prices." He further adds, "Once the US stops its anti-gold stance and marks its gold reserves 'to market' as the euro does, there will no longer be an official reason to suppress gold, and gold will be allowed to soar to its physical market equilibrium, which I think is far higher than anyone expects—especially in dollar terms. Physical gold will be the ultimate investment at that time since all—at least dollar based—paper investments will be near worthless then."

He further adds, "it will be in the interest of the rest of the world's central banks to support the dollar vs. gold, because now there is a new factor in the money equation (euro—an alternative to the dollar), a factor that has not existed since the world decided to continue to put its faith in the dollar despite Dickie Nixon's default on the US' gold obligations in 1971.

Every country but the US has no reason left to push gold down. They know that 'high gold' will help support their currency reserves—and thereby the value of their own currency. And they also know that high gold will eventually kick the US economy's rear end. US policy makers are either blind to this, or are fully aware of it but are running out of options. The only options left are too painful for them. Either

dollar for the medium to long-term is still bearish.

O Do you think that the present spurt in gold prices can be sustained in the long run?

At the World Gold Council we are not permitted to forecast prices. What I can say, however, is that when gold price moves rapidly, as it did in March of this year, this tends to have a negative effect on demand (and it doesn't matter whether that price movement is up or down—it is volatility that is the problem).

Changes in the demand side, even at the very grass root level, filter into the international market very quickly, sometimes in a matter of hours, because merchants know how the trade will respond to price movements and reflect this back to banks very rapidly. Consequently, gold tends to be one of the least volatile assets. When it does show a trend it tends to be defined by periods of stability, followed by a change in range, followed by another period of consolidation, and so on.

O In the currency war of dollar vs. euro, do you subscribe the notion that gold will benefit?

Gold almost always benefits when there is volatility among the major currencies because that is one of the times when it reasserts itself as a reserve asset.

O In the current scenario gold soared the heights that was never imagined before. Do you agree? Elucidate.

Gold only reached $388/ounce, by comparison with the very rapid and completely unsustainable rush to $850/ounce in January 1980. In rupee terms it has been at record levels, partly because of the movements between the dollar and rupee. Volatility and a poor harvest last year both therefore reduced Indian demand, but it has stabilized and improved this year despite higher prices, because it is such an important part of the Indian society and consumers have got used to higher prices.

O Market analysts opine that the present rally for gold is unique. Kindly elaborate.

It is not. It reflects the perception among professional and private investors of the need to manage risk (see the earlier answer), underpinned by steady fundamentals.

O Any other issues you would like to comment on?

It is always worth bearing in mind that because gold is not a fiat currency, i.e., it is not 'issued' by any particular country and therefore has no one else's liability attached to it, it works as an international asset. One of the reasons why it is seen as so important is that it reacts differently from virtually every other asset class to changes in the economic and financial environment. These two factors make it an extremely important asset when it comes to reducing risk, whether that risk is political, economical or financial.

way, those are the reasons why gold will climb, and climb, and climb—and stay there for good. Because this time, it's really different."

Unlike other currencies, gold is durable, handy, and valuable, which is why the market chose it as the dominant money before the age of paper money. It possesses all of the attributes of an ideal medium of exchange.

Outlook

After touching a 21-year nadir of $252.85 on July 20, 1999, gold prices have risen 36% to $342 by July 15, 2003 mainly attributed by investors' fears about global terrorism, the world economy and the decline in the dollar. Coming to the future trends, opinions were divided on the yellow metal. Bankers expect gold to struggle in the future without a sustained pick up in demand for the metal for jewelry and investment purposes.

However, Wayne Murdy, Chief Executive Officer, Newmont Mining, the world's biggest gold producer, was more optimistic. His views are similar to those held by other mining companies. Gold price will further upside in the foreseeable future given the poor outlook for the US dollar and low interest rates. There is near-consensus among the industry that the gains, which have mostly occurred since the start of 2002, were more to do with the 30% plus fall in the US dollar against the euro since February 2002 than underlying supply and demand.

In testimony to Congress, Greenspan signaled he was ready to keep US rates low for a 'considerable' period of time to lift the sagging economy and ward off the threat of a dangerous fall in prices. Greenspan knocked gold off. As one trader observes, "Most of the day had been spent looking at the euro, and as (the euro) came off, the strength disappeared."

Whatsoever, gold's luster was not expected to dim with analysts upgrading gold price assumptions for the next few calendar years. Merrill Lynch analyst Matthew Starick has released a report which predicts a bullish gold future and upgrades gold price assumptions for 2003 and 2004 by 3.1% and 7.1% respectively to $350 an ounce and $375. The analyst also increased the long-term gold price assumption to $350 an ounce, up 7.7% from $325. "The revisions, both near and long-term, are based primarily on our outlook for the US dollar and our expectation that it will continue to weaken against most major currencies medium term, before settling nearer current levels long term," says the report.

Alex Wallenwein suggests that "Save your family's finances and buy physical gold, take delivery, and hang on to it for all it's worth. There will never be a chance like this one to acquire real wealth at flea-market prices again."

N Janardhan Rao

Reference # 1-2003-08-07

MARUTI IPO'S SUCCESS

Breaking the ice

The Indian primary markets have not witnessed a remarkable response to an Initial Public Offer (IPO) like that of Maruti for quite some time. Does this signal any revival of the waning primary market?

Hats off to Maruti! True, to the much-hyped road shows and publicity campaigns, the IPO of the Indian automobile giant (the first ever PSU to be divested by the Government of India through the market route instead of a strategic sale) received an overwhelming response, both from institutional investors and retail investors. The government as a result of this exercise would divest 25% of its stake in Maruti. Keeping in view the oversubscription (of nearly 10 times) to the issue, the government further decided to retain 10% of this oversubscription, by means of exercising the green-shoe option. This implies that henceforth the government equity in Maruti would come down to about 17% from 45%, which, the government has an option to divest within a year either by selling it entirely to the Suzuki Corporation, its joint venture partner or via the market. The government had approved a cut-off price of Rs. 125 per share, which is Rs. 10 higher than the floor price of Rs. 115 per share. On the listing day (July 12, 2003), Maruti's shares were quoted at around Rs. 170 per share, which is inline with the market expectations of quoting above the government approved price.

Even though it is the institutional investors who have led the race for a pie in Maruti on the first day of opening of the issue (June 12, 2003), in the real sense it was the retail investors who have stolen the show all the way through the offer until it was closed on 19th June. As a reward to their enthusiastic participation, the government has decided to allocate nearly 60% of the total 79 million shares to retail investors and the remaining 40% to Qualified Institutional Investors (QIIs). This indeed, is against the Sebi's norms for allocation of shares issued through book-building process, which states that any unlisted company coming for an IPO through a complete book-building process should allocate 60% of the total shares issued to QIIs and the rest to the retail investors. The move by the government then, to allocate 60% of the total shares issued to the retail investors should not be perceived as a violation of Sebi's norms, but as measure to regain the retail trust in the primary markets. Two questions immediately crop up and in fact, they have already become debatable among analysts who are following the entire Maruti IPO saga with keen interest:

- What are the various factors that have triggered such a massive participation by the retail investors?
- Will this success revive the ailing primary markets?

Reasons for success

The timing of the issue was perfect. The markets have been rallying successively in the recent weeks, up from their lowest levels since April last.

While some analysts attribute this euphoric response to the good faith (ignoring the arithmetics of investment), the retail investors had on Suzuki Motor Corporation, which is a strategic partner of the Government of India others argue that the strong fundamentals of the company prompted the retail investors to believe that Maruti is going to thrive in the future, irrespective of competition, as it had been doing till now. As if a vindication to the investors' beliefs, the company had declared 30.8% increase in its profits for the first quarter of the fiscal 2003-2004. By making the issue a huge success, the retail investors appear to have kept aside all their fears about the negative aspects (like its lack of competence in the B and C car segments) of Maruti, at least for a while and relied only on the positive aspects. "This IPO is one of the rare good ones in a long time and people have just piled on to get a piece of the action," says Dr. VVLN Sastry, Country Head of Firstcall India Equity Advisors Pvt. Ltd., Mumbai. According to him, the following factors facilitated in fetching a good response for Maruti IPO:

- An IPO from a stable organization for the first time, posted 2001 bearish market sentiments.
- Attractive pricing range through book-building route.
- Volatile secondary market situation and no set pattern of trend prevailing in the secondary markets.
- Prevailing low interest rates trend and investors' long wait for alternative investment avenues.

The Indian banking system played a major role in the huge oversubscriptions that Maruti IPO had. Easy and cheap bank financing by both the private sector and the public sector banks is another factor that had, to a large extent fueled the rush of the retail investors toward Maruti IPO. This is because investors believed that they can easily mop-up up to 20% in return on their investment by selling post listing, just in about a fortnight, given the interest the issue had created among the investors countrywide. On their part banks,

"Feel good factor is higher when secondary market is buoyant"

Deven Choksey, Managing Director, Choksey Securities, Mumbai

O On Maruti iPO's overwhelming success.

It is normally seen that primary market catches up with secondary markets. Maruti IPO evoked good response not only due to vibrant secondary markets but also the merits in the offer. It is expected that more such quality PSUs would be offloaded through IPO which would certainly revive the IPO market. Maruti IPO though aggressively priced offered an attractive opportunity to invest in an automobile company priced at forward P/E of 8-10 as against other listed stocks trading in the range of 12-15.

O On support from retail investors.

First, in the book-building process, the retail investors (those applying for less than 1,000 shares) are offered shares at a cut-off price, as against institutional investors who had to place the bids. So the investors could get the shares at cut-off price, and they need not get into the intricacies of valuation of the shares.

Second, ample availability of funds (through IPO financing schemes of banks and NBFCs) made retail investors avail the opportunity to apply for Maruti IPO.

Third, Maruti happens to be one of the largest passenger car company in the country, and any investor would be interested in having a stake in this company, given its sheer size and a strong brand equity.

All these three factors taken together made retail participation in the IPO an overwhelming success.

O Efficiency and benefits of the book-building process.

The book-building route allows the investors, especially wholesale and institutional investors to make bids at the price they find realistic. Thus the investors are able to value the shares, and at times, can result in a better valuation. Also, it brings about transparency in the valuation of the company, take MUL for instance. The cut-off rate was higher than the floor price.

Benefit to institutional investors is that they can take a contrary view on pricing while bidding for higher quantity. Thus their acquisition cost comes down which is higher when resorted to in secondary market operations. For retail investors, they get chance to acquire shares at cut-off price which gives them entry into the stock at fair price. Thus, both classes of investors are taken care of for the varied requirements they have.

Market is a broader entity. Higher price paid on acquisition of shares is always associated with risk. While one argues for possibility of malpractices, it has limited scope even if it happens at times. Generalizing on this aspect should be avoided, as the system has more merits than limitations.

O Should Government take cue from this success?

Yes. This route offers the best route for the government to divest its holdings in the PSUs at the best rates. Also, the decision to offer allotment to every retail investor has enabled the retail investors create wealth. This move has evinced greater interest from all corners of the investing community, and would help in divesting its holdings in other PSUs at a favorable price in the future. If we are reading the confidence of Divestment Ministry, they are actually lining at least 10 PSUs through IPO route while divesting the stake.

O Outlook.

Maruti has resulted in giving 50% actual appreciation to investors from its cut-off price, immediately on listing. Obviously, the rewards would ask many investors to consider IPOs favorably than before. Feel good factor is higher when secondary market is buoyant. The book-building exercise and the overwhelming success of the MUL IPO has undoubtedly created renewed investor interest towards capital markets in general and equities in particular. This is a good move ahead, and would help in creating a buoyant and deep market, with increased investor interest and activity. However, I would advise the investors to have some patience and conviction on the company, as the valuations would slowly improve with improving performance of the company and improving prospects for the industry at large. At the end of the day, only long-term investors are the one who have created wealth. Invest in a company taking a medium to long-term perspective of the company, its business, and its prospects. You will definitely amass fabulous amount of wealth.

for financing the retail investors, had only put one condition—that investors should sell shares in secondary market at a price which is one rupee higher than the final issue price on the day of listing.

Triggering revival

As regards to the question of the resounding success of Maruti IPO triggering a revival in the primary stock markets, rather than an optimistic temper, a typical kind of skepticism is prevailing in the markets. The market is divided on this front. But the good thing is that a majority are of the view that this IPO would surely generate a positive atmosphere where the companies can be confident of approaching the market for funds and the investors can think of again entering the primary markets. A win-win situation for both the participants! There were even comparisons that the Maruti IPO is akin to that of the recent offering of the public issue by Benfield Group (an insurance broker) in London, which was oversubscribed by more than 12 times, triggering a revival of the primary market in London. "The success of the Maruti IPO with the huge participation of retail investors cannot be stated as the return of the retail investors to the capital markets nor it can be understood as revival of the primary markets. The real acid test for

stating that the retail investor is back into the markets can be the time when we find a series of private sector IPOs getting subscribed successfully followed by their active participation in the secondary markets. The scenario has to still emerge," says Dr. Sastry, echoing the general sense of skepticism that is prevailing in relation to the primary markets. In a nutshell it can be stated that the Maruti IPO was able to bring back the good sentiments among investors, but the investors are keenly watching the trends for their come back.

The government too, for its part had been trying hard to revive the Indian primary stock markets by initiating various measures (through the market regulator Sebi), which would regain trust in the investors as the Maruti IPO is a right step in this direction. This was reflected in the observations made by the Disinvestments Minister, Arun Shourie during the first road show held in Mumbai for promoting the Maruti IPO that, "This IPO is an important step to strengthen the primary markets and its success will set the stage for disinvestment at companies such as Nalco and BPCL where the government is looking at exit routes partly similar to Maruti's." The success of this issue also helps the government to revive and hasten the pace of the privatization of its PSUs. Considering the unprecedented response that the Maruti IPO had received from the markets, it can be inferred that the government had partly succeeded in its efforts to activate the primary markets, which have been going through dormancy for many years. However, amidst this successful story, an important aspect related to the issue that went unnoticed is the increasing prominence of the book-building process.

Book-building process

The Maruti IPO is regarded as a historic and the largest public issue to be ever made completely through book-building process. It is historic because none of the issues, which were made in the past by the companies, like Bharti Telecommunications, Iflex Solutions, Cinevista and Cadilacare through the book-building route were not successful and not impressive enough in providing the much talked about transparency and flexibility in price realization for investors. Of course it has to be mentioned that all these issues were made partly through book-building and partly through the fixed pricing offer. But, even then the reality remains that the basic purpose for going public through book-building was not achieved by these issues. Since then, a debate has been going among the elite as to whether the book-building route is a preferred choice or not for mobilizing capital from primary markets. "Book-building has a unique aspect within itself, which is price discovery in a set range of mini-max," observes Dr. Sastry.

Observing the overwhelming response that the retail investors gave to the Maruti IPO, the market watchdog Sebi had announced certain measures which would further clear the way for more retail participation and bolster the primary markets. These include:

- Reduced listing time from within 15 days of closure of the issue to six days of closure of the issue
- Reduced mandatory institutional investor allocation from 60% to 50%.
- Rs. 50,000 set as limit for defining retail investors in issues, which are book built. This implies that the retail investors would now be allocated shares on the basis of the amount invested and not on the criteria of the number of shares applied for.
- Green-shoe option made mandatory in all primary issues.
- The floor price of the issues to be replaced by a new concept, which would be decided shortly. All these measures are intended to ensure greater protection to the retail investors in the wake of the allegations that book-building process is more vulnerable to discrepancies than the normal IPO offer. Better hope that the transparent price discovery ensured by the Maruti IPO would further boost the book-building mechanism.

Conclusion

While the Maruti IPO had certainly shown the government a road map for divesting its stake in some of the PSUs like Nalco, BPCL and ONGC, the fact that Maruti got such a tremendous response because of having Suzuki Corporation as a strategic partner cannot be ignored. "Government definitely should take a cue from the success of Maruti IPO. Hitherto the government for the divestment process was dependent on the response from few select leading corporates. As these corporates also started using leveraged buyout's mechanism for the acquisition of PSUs, not much of fresh flow of capital emerged from these divestments. Now that Maruti has shown a road map, in terms of wider investors participation, definitely, government should exercise various possible options for divestment process," says Sastry. He further adds, " it's not a bad idea to float a normal IPO and have the participation of public completely in the divestment process." This is the appropriate time for the government to hasten its disinvestment program via the market route, because the investors appear to have perceived a feel safety factor in the PSUs.

There are of course downsides, but it is time to keep them aside and give full credit to Maruti for igniting investor sentiments and reviving what appeared to be a dormant primary market. It's now up to those companies, with their IPOs like TCS, Nalco and BPCL to leverage this situation.

Ramakrishna Neti

Reference # 1-2003-06-08

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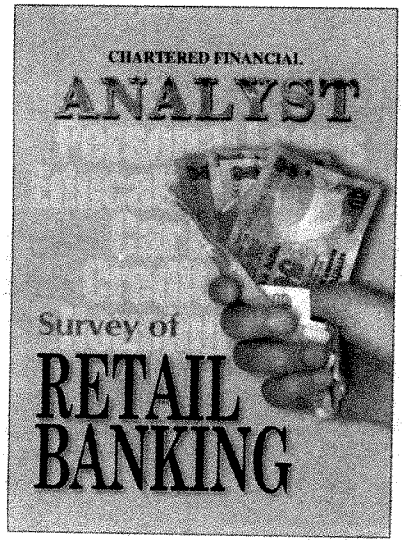

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Overview

The Retail Thrust

Indian banks at the backdrop of poor credit off take by big corporates, have found a worthwhile alternative area in the form of retail banking. The increasing emphasis by majority of the banks on retail banking is a clear indication of the state of affairs. "Lending to big corporates and creating loan assets," is no longer the name of the game. Suddenly banks have realized the importance of consumer credit, which was considered as unproductive in the past. In fact, consumer credit triggers demand for consumer goods and services, which in turn spur the economic activity.

Higher middle class with rising disposable income, changing life styles / aspirations and willingness to spend more for luxuries are some of the factors that have propelled the banks to foray into retail banking. Though retail banking was prevailing for a long-time, the emphasis was restricted. The downside is less in case of retail banking as compared to lending to traditional sectors like industry, commerce, project financing etc. This is true especially in slowdown times, as lending to corporates is more risky in view of the uncertainty prevailing in the economic environment. As a result of these factors, retail lending during the last three years has almost doubled. Today, the size of retail banking market is to the tune of Rs. 50,000 crore.

As the market size is enormous, the competition in the retail banking segment is also intense. Almost all the public sector banks, private sector banks and foreign banks are eyeing this highly lucrative market. In order to tap the huge market potential, banks are aggressively marketing their retail banking products. Innovative marketing strategies and promotional techniques are being used including the utilization of Internet. Intense competition together with economic conditions have resulted in a sharp decline in interest rates also. Interest rates charged on housing loans were as high as 18-20% a few years ago. This has come down to around 10% today. It's the same with educational loans, personal loans, car loans etc., and service standards have also improved tremendously as a direct result of competition.

For the banks to compete and succeed in the retail banking market, new initiatives and innovations, new strategies, new delivery mechanisms and ability to cross sell products, are imperative. At the same time, banks should align themselves with customers and become more customer-centric with proper emphasis on relationship management.

Y Chandra Sekhar
Survey Editor

A New Prospect

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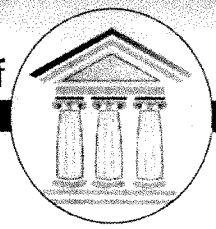
Slow credit demand from corporates, low interest rates and prudential norms are forcing the banks to move towards new avenues. Also the scope for substantial deployment of funds, which offer better risk-return trade-off and a well diversified credit portfolio are the imperatives that literally led the banks to go retail.

The current economic environment which is sluggish in industrial production and new projects has resulted in poor credit absorption both for long-term funding to big-ticket projects as well as working capital. The slowdown in the economy as well as lending to corporates at unjustifiable rates taking into account the banks' cost of funding, operating cost and risk premium has resulted in limited lending opportunities to banks. Major portion of the loans raised by corporates were to replace the existing high cost funding and is more in the nature of arbitraging on the interest rates with various banks. The loan products to corporates with strong financials now are almost linked to prices of government securities/or mark-up over government paper.

To survive and prosper amid the rapid changes that continue to redefine the financial services marketplace, banks hitherto concentrating on corporate borrowers are embarking on a strategy driven by retail banking in order to maintain asset growth and profitability.

Proactive Banks Taking the Lead

Retail banking includes comprehensive range of financial products including deposit products, residential mortgage loan, credit cards, auto finance, personal loan, consumer durable loans, loan against equity shares, loan for Initial Public Offer (IPO), debit cards, bill payment services, mutual funds, investment advisory services etc., which provide an opportunity for banks to diversify the asset portfolio with high profitability and relatively low NPAs. The most proactive banks have entered the retail banking and have identified it as the principal growth driver and are slowly gaining market share in the retail space. The retail asset portfolio of banks have grown substantially during 2001-02. Foreign banks are also securitizing vehicle loans to rise off-balance sheet resources and reducing the overall cost of funding. On the other side of the spectrum, as per press reports, Bank of Muscat is taking over auto loans and personal loans from other banks signaling a softer interest rate regime for consumer finance and giving an indication to intensify competition in business. It is appropriate to mention that Standard Chartered, through its credit card is now offering finance and whose repayments can also be spread over 6, 12, 18 or 24 months. The simple rate of interest of around 14% on credit card signifies intense competition and a softer interest rate regime for retail funding. On a priority basis, proactive banks have improved on their low cost savings bank deposits. The focus is due to the increase in credit



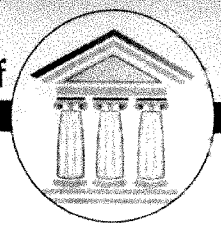
exposure to the growing residential mortgage loan segment, where the liability structure of banks can result in a tenure mismatch when lending long-term to the housing sector. A major part (>50%) of the savings deposits has a core component, which may be considered as more stable based on past experiences under normal conditions. This could provide relief to the asset-liability mismatches for banks when lending long, particularly in the case of mortgage financing.

The critical success factors of banks, which are aggressively moving in the retail banking segment are wider distribution network, low cost of funding, low intermediation (operating) costs, marketing capability, large product portfolio, cross-selling, proper credit appraisal mechanism/risk assessment procedures, high service levels in terms of faster loan processing and disbursement, flexible technology across banking platforms, multi-distribution channels, strong brand presence and good recovery mechanism. These success factors would ultimately transform to the ultimate result as to how well banks understand their customers and how effective they are in meeting their new definition of access, convenience and value.

Risk management and marketing should go hand in hand

Considering the aggressive growth strategies in retail banking pursued by banks amid intensifying competition, banks may compromise on the credit quality. Though there is a conflicting interest between risk management and marketing, however, both should work towards a common measurable target, which combines both volumes and bad debts. The sound credit scoring models should not be limited to assessing creditworthiness but also used for predicting potential bankruptcy, revenue response, profitability attrition and also fraud. Besides, banks have to move from mass marketing where 'one size fits all' to targeting specific customers based on their behavior, needs and value. The customer database maintained by each bank would be handy to study customer behavior, needs etc., to respond with the right product at the right time through the right channels and deliver conveniently, efficiently and effectively.

The international trends show that large losses can be related to retail loan portfolios and hence there is a need to tread cautiously and proactively manage risks. Though portfolio of retail loans is better diversified when compared to corporate loan portfolio, a systemic risk arising out of macroeconomic shocks could still have a large negative impact. The risks include, deficiencies in lending policies, incorrect product structuring, inadequate loan documentation, deficiencies in credit appraisal, absence of post sanction surveillance and monitoring, inadequate risk pricing, inadequately defined lending limits and weak collection strategy. All the decisions throughout the credit cycle i.e., marketing, application processing, accounts management, collection, recoveries have bad risk implications. Banks need to understand repayment behavior in a retail portfolio in relation to internal credit and marketing policies and outside economic and market influences. This would help them to respond to changes, project and make provision for forward bad debt expectations resulting in a good retail credit risk management. Banks with proactive retail credit risk management processes will be well-positioned and able to achieve healthy growth in terms of both business volumes and profitability. This would facilitate them to capitalize on the emerging opportunities and meet the challenges of the competitive environment transforming banks into an integrated financial service providers or a virtual universal banks.■



A Steady Approach

V K GUPTA
Business Head-Retail Banking
Global Trust Bank Limited

In sync with the developments in banking sector and economic environment, there is a tilt towards retail banking. Striking a right balance between retail banking and traditional banking is important for long-term sustainability.

Since the year 1960, banking industry is the only industry, which has grown at a compounded average annual growth rate of 15%. There are few industries that can match this growth rate on a continuous basis. Every industry has its peaks and troughs but banking industry is a very consistent industry. I really don't see any reason why in the next 10 years, banking should go down, 10-15% of growth is bare minimum and probably it will be more.

Banking is really into financial services and that is one market, which never dries up. Whatever you do, any economic activity requires finance and so, banking is always in demand. It's not like any other industry where sometimes there is a huge demand and sometimes the demand goes down.

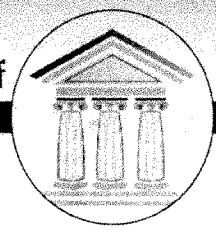
Indian economy is growing at the rate of at least 4-5%, which is the fastest in the world right now. Over the last 10 years since the reform days, Indian economy has gone through a structural change and a lot of efficiencies have now come into the industry like for example, costs have come down, lot of streamlining have taken place, excess staff has been rationalized.

Competition

Competition is intense but at the same time there is room for everyone. If the market was not growing then competition would have been a problem. Today any bank that has got the right system, right people and the right aptitude, can grow and only those institutions that do not read the pulse of the market will probably face problems. Even today, after 56 years of independence, 40-50% of the population does not have access to banks and with the rising income level these people will move towards banking rather than moving away from it. So the growth potential is huge. If you look at the sectors like retail banking and retail finance particularly, they started 4-5 years back only and we have not even scratched the surface because they had gone to metro cities and some of the tier-2 cities. We have to target the tier-2 cities and rural market fully.

Are banks overemphasizing on retail?

Ultimately there have to be a balance among things. Right now everybody is talking about emphasis on retail banking but you look at any bank's share of retail banking as compared to their total business. Till today not a single bank has reached 25%. There is a lot of talk but the proportion of retail banking is very small even now. I feel that it not a cause to worry. Retail is a volume-driven business. What we need to worry is to have systems and procedures to handle the problems. It is not the share of business. It is very low but the volumes are very large and what banks will have to ensure is whether they have the right people, right technology and right controls and procedures in place. Once these things are in place, retail will be a very profitable avenue for banks. ■



Retail Banking: Growth Strategies

HEMANT KAUL
Sr. Vice-President
(Retail Banking)
UTI Bank

To be successful in retail banking sector, overcoming competition by leveraging technology and human capital is critical.

The growth of retail banking in India is very exciting and going very well and there are tremendous opportunities in the near future.

Few factors have contributed to the growth of retail assets or retail financing. (i) The changing psyche of typical Indian and (ii) Opportunities are opening up with inflation having come down and rate of interest having come down too. Average Indian's ability to take credit has increased. If you were to look at retail spending as a percentage of GDP, that was to be taken as an indicator, whereas retail credit of present GDP is perhaps 2% in India. It ranges from 17 to 48% in our immediate neighborhood, South-East Asia. So, that is the potential that is available and we are waking up to it.

Marketing strategies

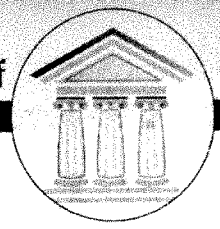
Marketing strategies would revolve around our own target segment that we are going to market in. During the life cycle of a typical customer he has different credit requirements at different stages of life. Initially when he comes in, he will look for a personal loan, we have a strong personal loan product. After sometime, maybe he will look for a two-wheeler or a car, we have positioned a strong car and two-wheeler loan. Customers around 30-35 years of age look for a home loan and for that we have an extremely strong home loan product. Not only have we developed strong products, we have also invested in creating infrastructure and delivery points. We have presence in about 100 cities across the country. We have a strong DSA network to market our products. We also have strong alliances along the ground.

Competition

There are two elements that are very critical to retail banking. One is the technology. Retail banking is extremely technology-intensive if you are talking about any time anywhere banking. Second, it requires superior human capital.

Technology

On IT front we are the state-of-the-art. We were the first in India to be on a centralized banking platform. Our centralized banking platform is Finnacle, which is provided by Infosys. UTI was the first bank in India to buy and implement Finnacle. Second, the moment you have centralized banking software, your entire financial data comes to reside on a single server in a centralized location but there is



a high risk also. If any thing happens at this data center, the branches and the ATMs will all be dead. Realizing this danger, UTI was the first bank in India to develop a disaster recovery site. Our data center is at Chembur, Mumbai and our disaster recovery site is at Bangalore. What it means is you need a server of similar capacity to be installed at the disaster recovery site. What is even more difficult and challenging is you require a network. It has to be in network with all our ATMs and branches with same bandwidth and same capacity and speed. We have to build a redundant network, a redundant server and most importantly, we have to ensure real time data mirroring. Data mirroring at our disaster recovery site takes place at a gap of five minutes. We don't wish anything to happen but if anything goes wrong at our main data server at Chembur, the bank would be up perhaps in a couple of hours with a data loss of five minutes. It is like buying an insurance policy not with the intention that some thing should happen to me and my family will be benefitted. It is rather for the piece of mind of my family and me. In this case it is for the piece of mind of the bank and the customers. We have the second largest ATM network in the country, among the best Internet presence in the country in terms of I-connect. So in technology, we are right up there among the best in the country.

Human capital

Average age of our employees is below 30. If you look at the educational profile of our employees, 60% of them have a professional degree. We recruit the best in the industry and pay them very well. We reward for performance and we are able to retain and grow them. So, once you have IT and educational profile then products and processes can be developed from these and that is what we are doing. Our products are among the most advanced and innovative and when it comes to growth, we are second to none.

Innovative products

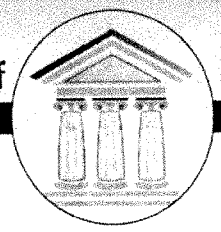
Let me speak of three products which are unique to UTI Bank and which differ from what anybody else is doing.

At Par Chequebook

Let us take a simple thing like a savings bank product. A common thinking would be that a savings account is a commodity. Savings bank account in Bank A or Bank B or Bank C is exactly similar to a savings bank account in the other bank and till recently, what made a customer decide opening an account in Bank A or Bank B was how close the branch of that bank is to his place of work or office. We have tried to break that by differentiating a product very strongly. There are two strong differentiators.

- We are the only bank in the country which to own a savings bank account is issuing an At Par Chequebook. What At Par Chequebook enables our customers to do is, issue a cheque, which will be treated as a local cheque at any center where we have a branch. The customer need not get drafts issued or pay orders made for making payments at these centers.
- If a customer gets transferred, he need not have to close his account and open up a new account. Two to three other banks having anywhere banking have facilitated the customers with ATMs and Internet banking but UTI is the only bank in the country to offer At Par Chequebook.

The At Par Cheque facility puts the entire UTI Bank network at your disposal. So if you need to send a payment to a payee



based in another city, town or state, you don't have to send demand drafts anymore. The At Par Cheque will be treated as a local cheque when it comes in for clearing at that center. The At Par Cheque gives the following benefits:

- Faster clearance of your cheque at any other UTI Bank center.
- Quicker cheque encashment by your payee.
- No outstation collection charges.
- Saves demand draft charges.
- No need to transfer or shift accounts when relocating to another city.

International Debit Card

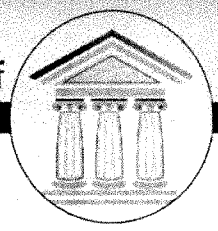
The other product is the international debit card. Many other banks issue international debit card. But our card has some unique features. UTI debit card is a photo signature debit card. Many banks are issuing non-personalized debit cards. The card does not have the photo or the signature of the accountholder. The photo and the signature besides personalizing the card also mitigate the risk. Suppose some other person is using your card. The merchant will know that the signature and the photo do not match. Another feature of this card is that we do not charge our customer for the card. All banks have Rs. 100-150 as annual charge. Our card is coming free to the customer. It is not only free for the primary accountholder but is also free for the joint accountholder. One more feature of the UTI debit card is that we have a built-in excellent insurance policy for our customers. Every debit cardholder gets a personal accident insurance of Rs. 2 lakhs from the bank. This is a very unique product and is a unique selling point for the bank. Any time when we are pitching for payroll accounts, employees find it exceedingly useful that we are able to provide an insurance feature without any cost to the bank. Some of the features of UTI debit card are highlighted below:

- Maximum cash withdrawal limit of Rs. 40,000. Highest among all the banks in the country.
- No annual charges.
- No additional card fee.
- Photo signature card.
- Personal accident insurance of Rs. 2,00,000.
- Purchase protection.

Mobile Airtime Refill

In line with our continuing efforts to make life easier and more convenient for our customers, UTI Bank introduced the refill facility for prepaid mobile cards. All UTI Bank ATM/debit cardholders can refill their prepaid card through UTI Bank ATMs or a single SMS. A one-time registration needs to be done at any UTI Bank ATM to avail of the SMS refill facility. Benefits of the service are:

- The facility can be used 24 hours a day at the ATMs or through the SMS channel.
- Refill facility can, through SMS, be used anywhere—even if you have a roaming account, and you suddenly realize that your airtime balance is running low.
- You can refill multiple phones through one UTI Bank account.
- No need to go to a retailer with cash to re-load your prepaid account. ■



Aggressive Strategies

R V SHASTRI
Chairman and Managing Director
Canara Bank

Huge untapped potential, rise in middle income population and shift in lifestyle have forced many banks to look at retail banking as a lucrative area. Banks are aggressively marketing their retail products in order to tap the huge market potential.

Robust growth in banks' advances during 2002-03 has been driven primarily by the buoyant retail sector. I feel, the retail boom is to continue in a medium-term perspective as well, because of the huge untapped potential therein, rise in the mid-income population, discernible shift in lifestyle and above all, due to the proactive instinct of banks to expand their retail base. Retail buoyancy is also on account of the cushion it provides to banks in terms of risk spreading.

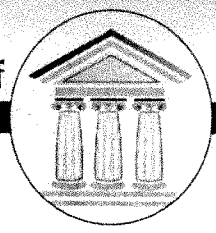
Tapping the huge market

Banks have been aggressively going about new marketing strategies, with the aid of dedicated outfits, to attract the retail business potential. Product development, product delivery and product servicing have been the three major planks of a discernibly different marketing ethos. Marketing of banking services, particularly the retail products, need personal touch with customers. With this perception, we are providing more thrust in the area of 'Relationship Banking' as a proactive measure to attract customers. These apart, repackaging of retail products with add-on facilities and competitive pricing are also being progressively adopted as strategic tools.

Focused attention on innovative marketing has paid rich dividends to banks and has stood them in good stead even in the face of downtrend in traditional lending avenues. Marketing has acquired new dimensions, more in the nature of a cultural change, and forms the core of strategic issues. Banks have been, by and large, successful in garnering adequate business volumes, which have made good the shrinkage in spreads. More than anything else, the resultant attitudinal change has been the most significant outcome of the new marketing strategies.

Improved service standards

There has been a perceptible improvement in the level of customer service in banks. But such improvements cannot be attributed to retail banking alone. In general, fierce competitive forces have led to a sharper focus on customer awareness and research leading to what is known as comprehensive customer relationship management mechanism. Insignificant product differentials have also made quality customer service the key to greater market share. There is also a growing recognition that progressive decline in margins necessitate a volume game and business volumes can be generated by effective service delivery mechanism. ■



Retail Banking: Thrust on Marketing

SHAHJI JACOB
Senior Manager (Marketing)
Federal Bank
Aluva, Kerala

With extremely low credit information on borrowers, and a market that is very highly competitive, the market is ripe for unscrupulous borrowers to make hay while the sun shines. This is something that the banks will have to look for.

A number of favorable factors both on the banking and the consumer market have been behind the recent growth in retail banking segment.

With the stock market in a strong bear grip, and other investment avenues like mutual funds turning unattractive, bank deposits continues to surge. While banks managed to strike gold through deployment of these funds in the investment market on the back of the declining interest rates, for pure credit they had to rely on the nascent retail segment. They simply had nowhere else to go as the demand for credit from the industrial and business segments proved to be very slack.

Retail segment was virtually a virgin market as it received very little attention in the pre-reform stages. Retail segment was often considered as unproductive spending and consumer goods financing as unproductive lending and thus less socially desirable. The low base of the portfolio provided the perfect platform for large and sustained growth over the past few years.

Lower interest rates, reduction in prices of assets through competition, reduction in import tariffs and duties etc., brought more goods within reach of the middle-income group.

Change in customer aspirations and mindset led the average household to desire for more conveniences and comforts. The electronic media has played a good role in bringing this about as it brought awareness and convenience of these products directly into the homes of the average person. Public seem to have become less credit shy which was further supported by the lower interest rate scenario in the country.

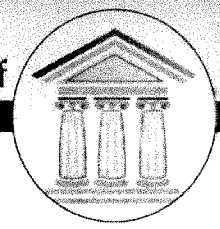
The history of low NPAs in the retail segment has been another factor that makes the segment attractive to banks.

Reaching out customers

Consumers have never had it so good as far as availing retail loans is concerned. Competition has ensured the lowest possible rates—in some cases just a few basis points above the rates offered on deposits.

For the customer, the major benefit has been the absence of hassles in taking a loan. Minimum documentation and doorstep service is a great change from the scenario a few years ago.

Competition is, however, getting unhealthy for the industry with margins dropping. In the anxiousness to gain an USP in the market, banks are throwing



caution to the winds with some banks offering loans in excess of 100% of the cost of the asset being financed.

New generation banks have been able to make the most of the situation as they have more operational convenience through outsourcing and direct marketing agents.

Old generation banks have woken up to the challenge and have done a commendable job in this segment in spite of the several barriers that they have in day-to-day operations.

Market is displaying a herd mentality blindly following the season's favor, which at present is no doubt retail advances. With extremely low credit information on borrowers, and a market that is very highly competitive, the market is ripe for unscrupulous borrowers to make hay while the sun shines. This is something that the banks will have to look out for.

Customer service

There is no denying the fact that the retail banking customer is receiving prime importance and a vastly superior service than ever before. The retail advance segment has clearly become a buyers' market with banks willing to be highly flexible to accommodate the fanciest wishes of the most fussy customer—i.e., as long as he appears creditworthy.

Retail loans are now marketed at the doorstep of the customer. Even in the case of deposit products, many banks offer doorstep banking services. Customers do not have to ever step into a bank, even to open an account be it deposit or advance.

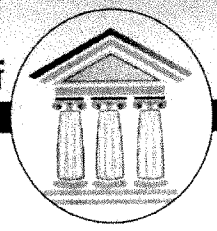
With bulk business customers proving to be very demanding and ready to hop from one bank to another at the drop of a hat, banks have come to realize the true worth of the ordinary customer. While earlier managers used to be given targets in terms of deposit size, today they are also expected to achieve targets in the number of new accounts. This has assumed particular significance as retail segment customers have the potential to improve interest spreads when compared to the larger volume customers who squeeze banks with demands for finer rates and other concessions.

Federal Bank's initiatives

While the bank has been matching the efforts of the new generation banks in the cities, we have been making good inroads in the second tier cities which are otherwise neglected by the market-savvy new generation banks. The bank has been targeting retail business both on the deposit and advance fronts by giving considerable thrust in these areas. This philosophy has led us to offer the latest IT-enabled products and services such as ATM, Internet Banking, Mobile Banking and Alerts and Debit cards at even small rural branches. We have thus enabled the population in these small areas to receive the same standard of banking service that is otherwise available in metros or other major cities only.

Recognizing the importance of gold loans to the people in rural and semi-urban areas, the bank has liberalized the norms for gold loans and made it more customer-friendly. Customers have now access to money in an emergency at low rates without having to depend on the local money lender who usually charges usurious rates of interest.

We have designed a bouquet of around 18 retail advance products to meet most needs of a typical customer of the bank, each tailor-made for the particular need.■



Growing with Retailing

AJAY BIMBHET
Country Head – Retail Banking
IDBI Bank

The focus on retail banking and the growth strategies pursued by the new generation private sector banks have ensured that now, it is the banks chasing the customers for business and not the other way round.

The retail banking segment has gone through a revolutionary transformation over the last five years. One cannot imagine that even as recently as a couple of years ago, a person had to take leave from office to go and withdraw cash from his bank—which could take anywhere between half an hour to an hour! Personal finance was simply not available to most people. If an Indian wanted to buy something, the only way to do it was to save up for it! No wonder, home ownership used to be at such low levels in India.

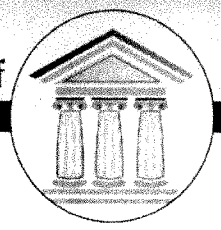
What has caused this transformation over the last few years is the introduction of global technology and products in India. India's ATM network is amongst the fastest growing in the world and is projected to be at 35,000 ATMs in five years. All the hi-tech service channels are now available in India. In fact, we launched mobile banking earlier than many western countries! Retail finance has made it possible for Indians to catch their dreams before age catches up with them. The average home loan taker's age has come down from the early 40s to early 30s. There are far more people buying cars, going on holidays etc., all powered by finance being provided by retail banks. The news has been good for the banks as well. Retail banking has pushed up profits for the banks and de-risked their portfolios. This revolution has been primarily driven by the new private sector banks. And I see this trend only catching on further.

Leveraging through technology

The trend has been to leverage technology and reach to improve service levels to existing customers and to penetrate deeper markets. IDBI bank has led the drive into tier-2 cities and I see more and more business coming from the smaller towns in India.

Banks have become far more marketing savvy over the last few years as they get more and more retail-oriented. Branding has improved dramatically. The manner in which branches and ATMs are presented to customers is far more savvy and customer-centric. Products are positioned in line with customer needs. Look at the dramatic increase in the customer base of most marketing-oriented banks! Banks can teach a thing or two to traditional marketing companies on effective selling in the services business.

IDBI Bank has clearly taken a tier-2 strategy in the retail banking sphere. We



have aggressively expanded our network in tier-2 cities and offered the latest banking services to them. It has even taken us by surprise on how quickly customers in smaller towns have taken to new technology-enabled services. Our dramatic growth over the last few years has come from this strategy and we will continue to focus on tier-2 cities going forward.

Changing paradigms

There is a notion that customer service has improved because of the shift in focus to retail banking. Over the last few years, the focus on retail banking and the growth strategies pursued by the new generation private sector banks has ensured that now, it is the banks chasing customers for business and not the other way round. Obviously, service standards have improved by leaps and bounds. Now, the customer is spoilt for choice in any banking product that he may wish to purchase. If there is a perception that service has improved, that does not surprise me. For a simple reason that this perception is based on reality. For example, there are some banks (including IDBI bank) that can give a provisional sanction for a home loan on the same day compared to many agonizing weeks in the pre-liberalization era. ■

Categorization of Retail Bank Services

Core Services	Facilitating Services	Supporting Services
Payment services	• Cash • Foreign currency requirements • Traveler cheques • DD/Bankers cheque • TT • EFT	• Making payments at door step • Internet banking • Telephone banking
Current account and savings account	• ATM card • Standing instructions from customers for making payments • Inter branch /interbank transfer of funds • Safety vault	• Credit cards • Debit cards • Services to senior citizens • Telephone banking • Internet banking • Conversion of excess balance to Time deposit
Loan products: Consumer loans, personal loans, housing loans, educational loans	• Current account • Savings account • Time deposit account	• Delivery of loan at promised time period • Interest rate option: Fixed/ floating • Flexibility in pre-payment of loan • Counseling on Real-estate markets • Legal services for documentation • ECS for payment of loan installments
Insurance products: Life insurance, pension schemes	• Current account • Savings account • Time deposit • Safety vaults	• Additional insurance facility for family members • Counseling on post retirement savings.

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OFF-BALANCE SHEET FINANCING

Time for a requiem?

An accounting change, that seeks to alter the way SPEs or off-balance sheet entities are treated, is making the entities run for their life. Corporate users, banks and financial market players are busy attempting to understand the potential impact.

Circa, 1998. Venue: Training class at Enron's Houston office. Enron's executives were undergoing a training program on structured financing designed to train them in the creation of complex financing structures and tell them how to achieve and maintain the off-balance sheet status, which was the most revered goal.

Little did those executives knew that their company's obsession with hiding debt, might eventually lead to killing the goose that laid golden eggs. At the time of Enron's implosion, the news that Enron had about 4,000-odd off-balance sheet entities with billions of debt hid in them came as a rude shock to all.

Circa, 2003. CFOs and finance executives are having sleepless nights over the prospect of having to consolidate all the financing that they so far did, by means of off-balance sheet entities and the resulting ramifications that it might bring. Market players in leasing, asset-backed markets, bankers *et al.*, are all worried whether their business will cease to exist in future.

A recent amendment to the US GAAP, called FIN 46, that seeks to change the way off-balance sheet financing is accounted for, is sending chill down the spines of CFOs and financial market players alike. Corporates are experiencing a double whammy. Enron-induced fears have made investors jittery about these entities. Thanks to FIN 46, sizeable corporate debt that has so far been hiding under off-balance sheet subsidiaries is likely to return to parents' books. A recent report by Credit Suisse First Boston reckons that this new rule will add almost $400 bn in assets and liabilities to the balance sheets of companies in S&P 500.

The threat to off-balance sheet financing mechanisms, once venerable products of financial engineering, and the markets that grew around them, range from possibility of extinction to large scale annihilation. Enron's abuse of SPEs (Special Purpose Entities) and its subsequent collapse have forced investors to hate companies that use complex financing mechanisms. If investor reaction in the case of Krispy Kreme Doughnuts, Inc. is any indication, it looks like the market is dictating corporate financing strategies through share price. When Krispy Kreme considered using an SPE, its share price trembled. Investor concerns forced the company to abandon the idea. Cisco Systems too, decided to abandon its use of synthetic leases in the wake of investor fears, long before FASB (Financial Accounting Standards Board) brought in FIN 46. Similar circumstances are forcing GE to rethink its reliance on securitization. Sears that brought its SPEs back to its balance sheet, has seen its share price rising, though return on assets decreased due to consolidation.

The threat to off-balance sheet financing entities range from possibility of extinction to large scale annihilation

Demystifying 'off-balance sheet'

Off-balance sheet financing mechanism takes many forms. Broadly, they fall under two categories. Those that involve the use of another entity and those that don't. The mechanisms of the former category or off-balance sheet entities are structured as separate legal entities that can take any form like publicly traded companies, corporations, partnerships, trusts or joint ventures. Such entities were floated for various purposes, from leasing to securitization of financial assets. These mechanisms offered their corporate parents, best of both worlds. Lower cost of financing, improved liquidity apart, they gave freedom to the parent from associated debt burden.

They were initially created to finance new ventures. Usually high-risk and heavy-investment ventures were separated from parent companies to avoid diluting existing shareholding or adding to parent's debt load. Oil-drilling companies created SPEs to finance oil exploration projects and thereby they could transfer the risk as well as get the projects financed without affecting their balance sheets. These SPEs were jointly funded by parent company and outside investors who were willing to take such risk. SPEs were also created by parent companies to pursue businesses that differed from parents' main line of business.

SPEs are also used by many pharmaceutical companies to fund R&D projects since they entail lower cost and also transfer the risk from their companies. Another form of off-balance sheet financing that relates to acquisition of buildings and plant and equipment, that drew a lot of criticism is synthetic leasing.

SPEs soon became crucial to securitization process. While financial institutions emerged as the largest users of SPE-led securitization, big corporates also used them to recycle their receivables as well as to finance their customer needs. The growth of asset-backed securities market (Asset Backed Commercial Papers or ABCPs, Collateralized Debt Obligations or CDOs and Mortgaged Based Securities or MBS) owes itself to SPEs. Securitization industry has grown tremendously and now stands at $6 tn.

Thus off-balance sheet financing, before being hijacked by companies to meet accounting objectives, represented a genuine financing tool that companies used to transfer risk, reduce cost of capital and to access alternative financing sources and capital markets. They are widely used by US companies across a variety of industries. There would be virtually no company in *Fortune* 500 that doesn't use SPEs.

Under pressure to meet Wall Street targets, companies started using off-balance sheet financing as a means to remove assets and liabilities from balance sheet, and to hide their actual financial position. By the end of 1999, Enron had moved $27 bn of its total $60 bn in assets (many of them were poor performers) into off-balance sheet entities to preserve its image as a dynamic and growing concern.

The parent companies, who shared majority risks and rewards, effectively controlled the business, though they were not regarded as the owners

Accounting facet

According to the accounting rules (before FIN 46), if an independent third-party investor, who bears risk and controls the SPE, contributes at least 3% of the value of SPE assets, the parent company was allowed to keep the SPE off its balance sheet. The crucial aspect of control was measured in terms of voting rights.

These rules laid ground for the abuse. Companies created SPEs that they technically did not own (by ensuring that independent third party contributes to 3% equity capital with voting rights) but assumed all the risks, liabilities and benefits of ownership. In such a mechanism, wherein the third parties were mere 3% owners, naturally didn't have their stakes tied to SPEs and hence lacked incentives to control the entity's business. The parent companies, who shared majority risks and rewards, effectively controlled the business, though they were not regarded as the owners, since ownership meant voting rights, which they happily relinquished.

This arrangement allowed parent companies to keep their SPEs off-balance sheet, with mandated footnote disclosure. These footnotes indeed, carried the information, albeit in a manner that was deliberately designed to conceal than reveal. Enron went a step further. It neither transferred risk nor its independent investors were really independent. Enron's case represents a clear case of full-fledged fraud that blatantly violated the crucial norms.

FASB came under intense pressure to close the loopholes, that led the corporate deceit go scot-free so far. FIN 46, which is in the nature of an interpretation to the existing accounting standards, amended the controlling interest criteria. Whoever shares the majority of the risks or rewards of the SPE are deemed to possess controlling interest according to FIN 46. The 3% equity criteria, which was clearly specified as a cut-off, would no longer apply. This cut-off has to be determined on the merits of each case. This approach appears to signify importance being given to substance over form. Another important aspect, which lends a broader scope to FIN 46, is its extension to all forms of financing mechanisms involving such subsidiaries.

The impact

The new regime offers companies two choices. They have to either bring their SPEs on to balance sheets or meet the requirements of new rules which may entail restructuring and higher costs. Companies that do not have to consolidate (those that are not primary beneficiaries) are also required to make disclosures about potential exposure.

Market experts believe that the the new rules do not apply to entities that are considered to be 'Qualifying SPEs' (QSPEs) under FAS 140, which generally include most SPEs created to facilitate issuance of asset-backed securities other than ABCP and CDOs. But ABCPs and CDOs happen to be the preferred choice among the corporates. Synthetic leases are also regarded as potential candidates for consolidation.

Banks are among the foremost to be affected, since they administer the ABCP conduits. ABCP conduits are SPEs sponsored and administered by commercial banks that finance receivables of corporate clients. Typically they buy receivables from various corporates and issue commercial paper backed by those receivables. Usually, banks also provide overall credit enhancement and assume responsibility for expected losses in the event that the conduits cannot roll over the CP. If the conduits do not have sufficient equity, as it happens in many cases, and if banks provide majority of the credit enhancement and/or liquidity, they may be regarded as the primary beneficiaries of the conduits and hence consolidation may ensue.

So depending on how FIN 46 is applied, it will bloat the assets of banks. Prof. Jayanth R Varma, IIM, Ahmedabad says, "Some banks and financial intermediaries may have to consolidate billions of dollars of assets in such SPEs."

If it is required to consolidate its CP conduits, Citigroup estimates that, its balance sheet size will increase by $51.9 bn. For Bank One it could mean an increase of $42.8 bn in assets. And for JP Morgan Chase it may be $17.5 bn. More significant aspect for banks, is that not only the securitized assets go on to increase banks' asset sizes, but also the increased asset size would trigger additional doses of 8% regulatory capital according to the Basel norms.

Undoubtedly all this would alter the economics of ABCP business. The future structure and growth of the $726 bn ABCP market will be determined by how FIN 46 is applied to this market. Some banks may decide to scale down while others may simply close their conduits. Many are looking at restructuring options like dispersing the variable interests such that no single holder has a majority of the variable interests or to gain QSPE status. Whatever alternative that banks may choose to adopt, it would definitely increase the cost and that would be passed on to companies.

Another area that may be affected is CDOs. These are often established as partnerships with one party bearing most of the risk and receiving most of the rewards. FIN 46 will require this party to consolidate. Restructuring options are available even in this case. However, this can be done only at increased cost. Synthetic leases are also considered as potential consolidation candidates. SPE of a typical synthetic lease does not meet the criteria for non-consolidation under FIN 46 as these leases usually involve a guaranteed return or purchase option from corporate tenants. This means that they would be the primary beneficiaries (for assuming the risk) and so will have to consolidate.

As of now synthetic leases worth $50 bn are structured every year. Majority could transform to alternative lease structures such as 'sale and lease back leases' or 'net leases'. This inevitably entails increased cost of financing.

Cost of Enron?

Corporate users of SPEs are facing no less heat. With the disclosure and consolidation requirements, companies that begin disclosing that their risk exposures are more than what they have always told, have to face serious ramifications. Companies whose SPEs have to increase their capital to 10% (this threshold is what experts consider as the new cut-off) of the assets would find it difficult as this additional investment can be acquired only at increased cost. Companies that fail to meet this higher bar would be required to consolidate the SPE, and this may result in bloated balance sheet.

CSFB report notes that balance sheets of 234 companies of the S&P 500 would be affected. As per CSFB report, assets of Citigroup and General Electric, heavy users of off-balance sheet financing, will face massive increase. The two companies have about $55 bn and $43.6 bn in assets, respectively, that could appear on their financial statements due to the rule change. Other companies whose balance sheets would increase by more than $10 bn, according to CSFB, are Bank of America, Ford Motor, General Motors, J P Morgan Chase, State Street Corp., and Wachovia.

Some companies are already feeling the jitters. ConocoPhillips, the third-largest US oil company said it expects to consolidate leasing arrangements onto its balance sheet as a result of FIN 46, and this will increase its debt by about $2.4 bn. Salomon Smith Barney Holdings reckons that it may have to consolidate up to $1.4 bn. For HSBC, FIN 46 could have a $2 bn impact on its books.

> **"We anticipate that reported debt will increase on the balance sheets of many, possibly increasing their costs of raising funds. Tax benefits may also disappear from the income statement of others increasing tax liabilities."**
>
> **Peggy Crawford**
> *Associate Professor of Finance*
> *Graziadio School*
> *Pepperdine University*
>
> **Edward Fredericks**
> *Portfolio Manager*
> *Eastwind Asset Management*

As the new rule will change the assets and liabilities, key ratios like debt-equity, debt to assets, return on assets would be affected. Operating and profitability measures will also be affected. As debt levels are all set to go up, credit ratings face the prospect of downgrades. All this will change the perceived risk of a company, and can send stock price trembling. Peggy Crawford, Associate Professor of Finance, Graziadio School, Pepperdine University and Edward Fredericks, Portfolio Manager, Eastwind Asset Management say, "We anticipate that reported debt will increase on the balance sheets of many, possibly increasing their costs of raising funds. Tax benefits may also disappear from the income statement of others increasing tax liabilities."

CFOs have to tackle increase in cost of capital. Companies that consolidate their off-balance sheet entities will report higher leverage

than before, which may increase the cost of new debt. In some instances, it could even impact the credit rating negatively. Companies that struggle to keep their entities off the books could find it expensive. Companies opting for off-balance sheet financing (like ABCP) in future would find such financing more expensive.

It resembles a Catch-22 situation. Peggy Crawford and Edward Fredericks, aver, "CFOs are faced with a quandary. They are tasked with insuring an acceptable cost of funding and may seek an off-balance sheet arrangement to provide it. However, to avoid consolidation and an increase in reported liabilities, they may turn to increasingly complex structures which may prove to be too expensive to implement. In any event, the SEC will ultimately see through the financial engineering 'smoke and mirrors' and demand consolidation. The attempt to lower the cost of capital may result in increased costs as the investment community reacts negatively to the increase in liabilities and bad publicity of an SEC order. The point is much effort, time, and money may go into a financing arrangement that ultimately will not suffice as an unconsolidated entity. The attempt to lower costs may result in wasted efficiencies and higher costs." Prof. Jayanth Varma feels that the biggest challenge for CFOs will be to deal with regulatory risk. Says he, "It is not enough to be compliant with current regulations. FIN 46 is an instance of an arbitrary change in the regulatory regime that invalidates structures that were perfectly legitimate at inception. This is the sort of risk that CFOs must learn to live with."

Conclusion

Will FIN 46 be able to prevent future Enrons? Peggy Crawford and Edward Fredericks feel that if management or employees of a firm are determined to hide extensive corporate liabilities from creditors, investors, and regulators, they will find a way and FIN46 or any other regulation will probably not stop them. "However, what FIN 46 will hopefully do is to increase transparency and help rebuild confidence in financial reporting."

Opines Prof. Jayanth Varma, "I do not think that FIN 46 will make much of a difference to future Enrons. Let us remember that Enron problem arose because they were not able to meet even the 3% requirement and indulged in an accounting fraud to hide their violation of this rule."

Another question is about the future of off-balance sheet financing. FIN 46 apart, FASB has issued draft exposure amending FAS 140, which experts say could limit the ability of QSPEs to retain that status. In such a state, future of the off-balance sheet financing is in doubt. Companies and securitzation industry threatened by FIN 46 feel that it is overly broad and an over-reaching measure to treat a very specific abuse i.e., costly repercussion of Enron that punishes legitimate users. Peggy Crawford and Edward Fredericks feel, "Off-balance sheet financing serves an economic purpose, but the structures should not become so exotic that investors, creditors, regulators, and analysts cannot evaluate their possible implications. We must carefully balance the need for financial innovation and the need for transparency." Prof. Jayanth Varma airs a similar feeling. He says, "It fulfills a genuine financial need and will continue to thrive despite the accounting uncertainties related to them. The accounting frauds of a few corporations should not blind us to this fact."

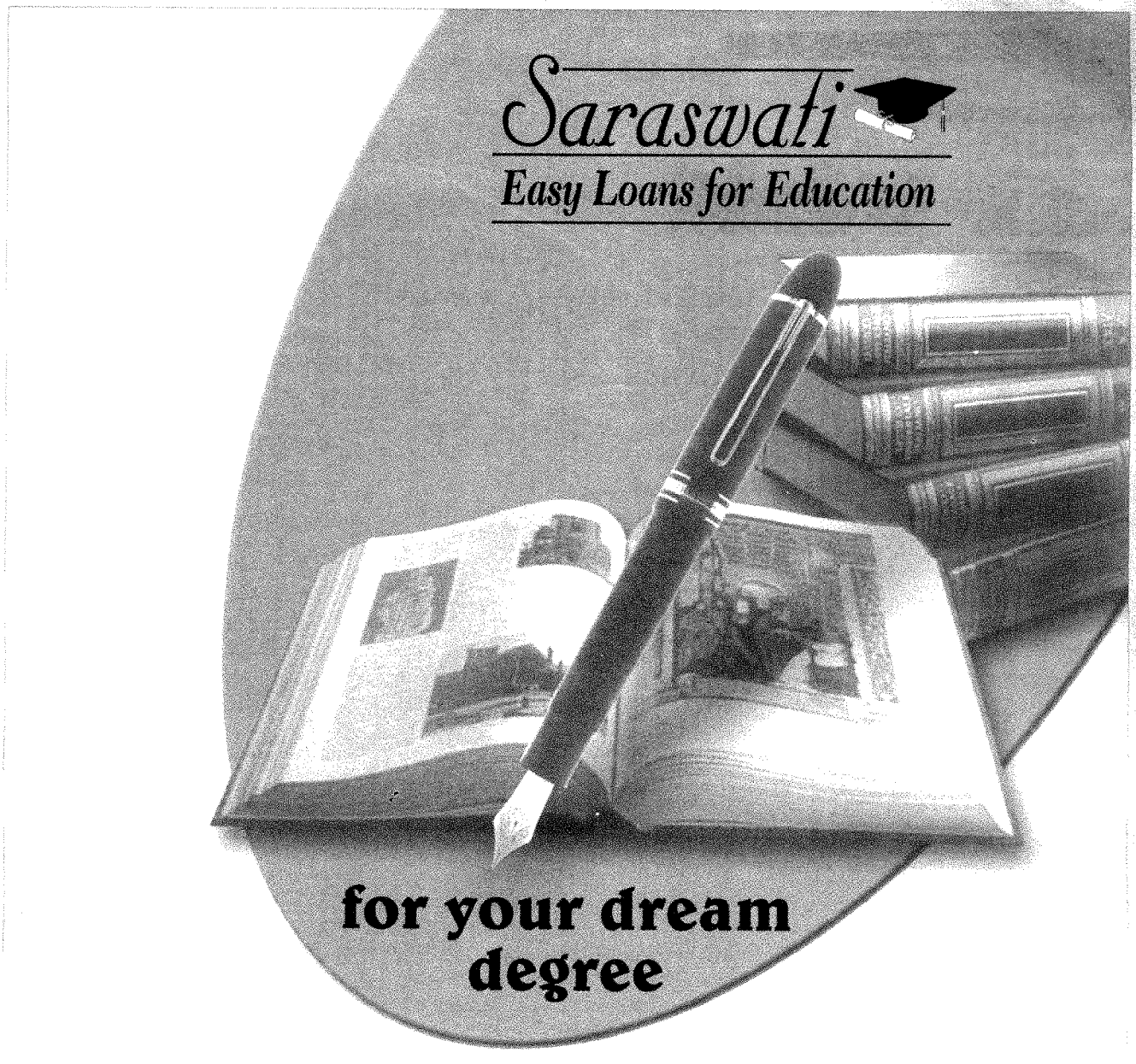
Will FIN 46 improve financial reporting? While FASB feels positive, experts feel that complex and subjective nature of FIN 46 increases the risk that it may not be consistently applied. Prof. Jayanth Varma says, "Investors must always look beyond the accounting numbers and digest all the information that is available. In this context, what is important is not whether SPEs are consolidated or not, but whether they are disclosed or not." This is what FIN 46 aims at. Until now neither financial institutions nor companies disclosed much about off-balance sheet financing. FIN 46 would result in full details regarding risk exposures and potential liabilities. Prof. Jayanth Varma feels that the disclosure requirement about entities in which companies have interest even those that need not be consolidated, is the biggest benefit. When something as dramatic as Enron happens there is always a danger of over regulation. The optimal result should be that all transactions must be obvious to all impacted parties and all parties must understand the risk implications.

> **"FIN 46 is an instance of an arbitrary change in the regulatory regime that invalidates structures that were perfectly legitimate at inception. This is the sort of risk that CFOs must learn to live with."**
>
> **Prof. Jayanth R Varma**
> *IIM, Ahmedabad*

Whether the changes would eliminate such entities or make the going difficult, what is emerging crystal clear, is that there would be a heavy price to continue such arrangements. In some cases, restructuring may help. For others the price may not be worth paying for at all.

Ch Rajeshwer and A Sowdeepti

Reference # 1-2003-08-09



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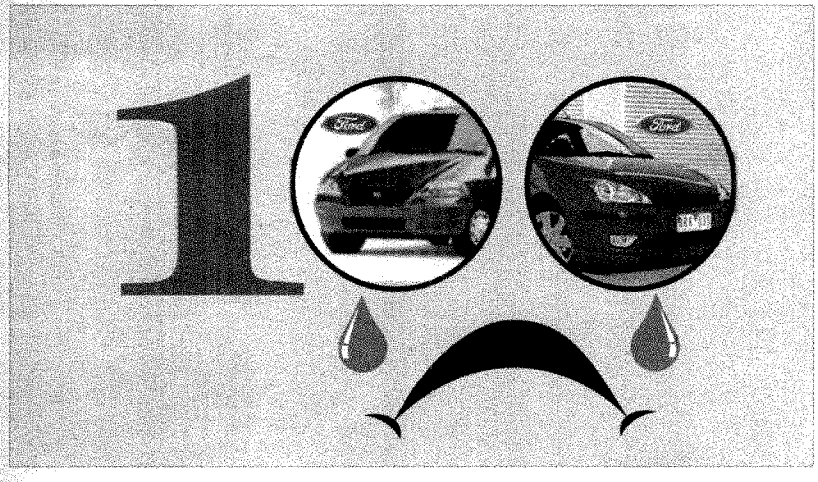
US AUTO MAJORS

Destiny in doubt?

Ford celebrates its 100th birthday amidst widespread gloom about the future of the big three US auto majors, GM, Ford and Chrysler. But it is too early to write them off.



It was exactly a century ago, in June 1903 that the legendary Henry Ford pioneered Ford Motors. He revolutionized business to be a way of life in America. His contributions to mass production and practices of business management have become a folklore taught in almost every B-school. Today, in the hands of his great grandson, William Ford, his legacy is precariously positioned. Ford is not alone in this predicament; General Motors and the smallest of the big three, Chrysler too are along with it.

Falling demand

Auto industry has traditionally been considered as a representative of the economic scenario. Thus it is a cyclical industry, which cannot really escape the economic booms and busts. But this time around, the recession in the US economy is proving to be a drag on the auto majors. US is by far the largest vehicle market and in the case of the big three, it contributes to a major chunk of their revenues. The forecasts are none too bright. autoPOLIS, a consultancy of automotive industry, predicts that the demand for new cars and trucks will be at least 15% less in the US despite generous sales, incentives and discounts. The other markets such as Europe, Japan etc., are not poised for growth.

The falling demand caused by the economic downturn was aggravated in the aftermath of September 11 attacks. In order to keep up the sales, GM pioneered heavy discounts as well as interest-free financing. These discounts have initiated a price war. Ford was left with no choice but to follow suit. And Chrysler, which had resisted offering discounts for long has also jumped onto the bandwagon. Even after two years, the discounts, are nowhere close to their end. In fact, they have placed companies in a vicious loop. With consumers expecting and getting discounts, automakers are in no position to reverse these incentives without severely affecting their sales projections.

While these measures sure keep the sales volume propped up, margins are taking a severe beating. James Durance, Research Manager, World Markets Research Center explains, "Incentives are likely to continue because automakers find themselves in an impossible position. Even GM, the original market leader in the incentives, in the wake of the September 11, 2001 attacks, has admitted that the pressure of incentives may not be sustainable, and is having a big and lasting effect on Detroit automaker profitability." He continues, "On the other hand, none of the companies can afford the risk of pulling incentives from the market and watch the market collapse, creating a vacuum that would need urgent adaptations in production schedules, employment levels, and capacity in the North American industry." Graeme Maxton, Economist and Co-founder of autoPOLIS (a strategy consulting firm which specializes in the automotive industry) warns, "The insanity of the incentives will take time to show their full impact." He predicts that this artificially stimulated demand would create a "fantastic glut of used vehicles, which has still to feed through to the market, crashing their residual values."

Japanese threat

According to autoPOLIS, six auto companies account for 72% of the global output while the top 10 companies account for 92%. The automobile market in US is dominated by two major categories of players, the three US majors concentrated in Detroit and the Japanese automakers, Toyota, Honda and Nissan who are located far from the motor town. The three Japanese automakers are fast making inroads into the American

markets with their sleek and compact models. The combined market share of these three Japanese companies has risen from 17.9% in 1996 to an estimated 22.6% in 2003. Maxton confirms "...the Japanese market share has increased and it is likely to rise further. Moreover, the Japanese tend to keep share gains high even during difficult periods."

Durance opines, "Helped by strong products, forays into new hitherto unchartered segments (such as the large pick-up market) and favorable currency exchange rates, Japanese automakers are hurting Detroit in the area of market share in their home market." He maintains, "This is a major problem for Detroit, which has in recent years relied heavily on its home market and the higher margin light trucks segments for a great proportion of their overall profits." SUVs or Sports Utility Vehicles have been contributing for more than 50% of the sales of US auto companies and supported their profits. Now these SUVs are not exactly the hot selling property. The demand is shifting towards small, compact, fuel-efficient family vehicles. That is an area where the Japanese companies have an upper hand. For GM or Ford launching new models in this segment would take at least three years.

There are many reasons in favor of the Japanese. The efficiency or productivity levels are much better. Ford requires 39.7 labor hours per vehicle, GM takes 36.7, and Chrysler needs 40.6. Compare this with Honda's 27 hours and one would be left with no doubt about the productivity levels. In addition, many analysts point out that the Detroit auto majors have to grapple with their highly unionized workforce (United Auto Workers), a hurdle, which the Japanese automakers do not have to deal with.

In terms of quality too, the Japanese car makers are much better positioned than their US counterparts. The JD Power and Associates survey of long-term vehicle quality polled 55,000 owners of three-year-old vehicles indicates that US automakers with the exception of GM have not been paying much attention to quality. Toyota Motor Corp.'s luxury unit topped with 163 problems per 100 vehicles. The industry average was 273 problems per 100 vehicles as per the survey and out of Detroit's three automakers, only GM ranked above the industry average. In terms of environment-friendly vehicles too, the Japanese carmakers score better. The SUVs of the big three automakers are a far cry from environment friendliness. GM for one has realized this and is focusing more on next-generation hydrogen fuel cells. Ford on the other hand, will be forced to postpone its self-imposed target of 25% reduction in fuel consumption in its SUVs by 2005.

GM's pension liabilities are a major matter of concern. GM has more than two retired workers for every existing worker

Different woes

The industry is loaded with overcapacity with an estimated one-fifth more capacity than it needs. In addition to the industry-wide problems that all the three companies face, each has its own Pandora's box. But the cumulative effect of the problems is felt on the 'bottom line' for all the three. Maxton sums up, "They have created a treadmill for themselves where prices are falling, sales are falling and the debt of all three has been downgraded to junk. The major problems of the big three are financial—although there are others—but the events of the last two years mean that all are in a precipitous state."

> **"The insanity of the incentives will take time to show their full impact. But if you drop the whole market price level by as a much as $3,500 per vehicle through incentives then, of course, you will stimulate the market."**
>
> **Graeme Maxton**
> *Economist and Co-founder of autoPOLIS (a strategy consulting firm which specializes in the automotive industry)*

GM's pension liabilities are a major matter of concern. GM has more than two retired workers for every existing worker. In addition to its almost century long existence, the restructuring and downsizing of the recent years have contributed to this highly unfavorable ratio. This translates into huge pension and healthcare expenses for the company. The falling stocks have further increased liabilities and increased the pressure on GM. In fact, GM's pension plans were underfunded to the tune of $19.3 bn, its healthcare costs were underfunded by $51.4 bn. The company was forced to go for a bond issue to the tune of $13.1 bn so as to "contribute significantly more to its pension or healthcare obligations or both than it projected this year." The company will be forced to pay penalty if it cannot make good the gap in its liabilities. It has avoided paying for the shortfall through the bond issue but how long will that sustain is a matter of doubt. Efforts to restructure the operations could lead to more job cuts and increase its pension burden. Durance airs his concerns, "...Bond issues, sales, loans etc., will help to plug the gap but the size of its pension liabilities means that it will remain a major priority for GM, and an issue that is unlikely to be solved in one go."

Huge pension and healthcare expenses are a grim reality at Ford too and both the companies claim this to be an unfavorable scenario for them as against their Japanese rivals. Maxton believes that is only partly true and reasons, "...First, Toyota, Honda and the others have smaller pension liabilities because they have simply been around in the US for less time. Their liabilities will eventually grow. Second, and more importantly, GM and Ford have much higher pension and welfare liabilities because they have been forced to downsize, because they have lost share, because they have not been as successful."

Ford, the second largest carmaker in the world is in a particularly vulnerable position. The company had recorded a staggering loss of $5.4 bn in 2001, after which William Ford took over control ousting Jacques Nasser as the CEO. For the financial year 2002, Ford was still in red (albeit a smaller figure of $980 mn) in spite of ambitious restructuring plans. Even after 18 months of his taking over, the top brass at Ford Motors is yet to be firmly in place. Ford has only recently named Don Leclair, a 27-year-old veteran of the company as its CFO. Till then, Allan Gilmour, the vice-chairman, who was pulled out of retirement in 2001 was performing the role. Ford has problems with its pension plans too but with a 1:1 ratio of retired workers to existing workers its problems in this front are less severe than those of GM. In fact, troubles at Ford have been so acute that Egan-Jones, a credit rating agency which prides itself on warning investors about WorldCom and Enron, has warned investors that Ford is dangerously close to bankruptcy; a claim the company dismisses as unfounded.

The company had announced a Revitalization Plan in early 2002, which sets out a restructuring map for the organization. It has recently announced its second quarter results. The company has reported pre-tax profits of $2.1 bn for the first half of 2003 as against pre-tax profits of $1 bn during the same period a year ago. However, the results for the second quarter itself were not encouraging with a 27% fall in earnings in spite of consumer financing incentives. The main culprit, Ford points out, is the bleak economic scenario that seems far from over. On the occasion, the CEO reaffirmed Ford's commitment to 'product-led Revitalization Plan' and plans to flood the market with its exciting line up of new vehicles. The first in the series, the new Ford F-150 pick-up is about to hit the roads very soon. Ford has set for itself an ambitious target of coming up with 65 new models in the next five years. There are also simultaneous cost-cutting measures such as proposals to slash down excess capacity. Major restructuring is going on in almost all the operations of Ford.

Chrysler, the smallest of Detroit's big three, which was taken over by the prestigious Daimler-Benz in 1998 is yet to deliver on the promises of profits. Instead of the earlier forecast of $2 bn operating profit for the year, the company has given warning of $1.2 bn operating loss for the second quarter. Chrysler's plants, as has been observed earlier, are the least productive of the three and it is reported that the company has 17,000 workers than it needs. Dieter Zetsche, the CEO of Chrysler, however anticipates a huge surge in sales and is in no mood to cut down the capacity. However, the poor demand scenario in the automotive sector as a whole makes Zetsche's assumptions unrealistic.

A way out

The problems faced by the three big automakers are real and they have changed the face of US automotive market. Some analysts believe that if the present trends continue into the future, the three big automakers would be in danger of losing their existence. But as of now, this notion seems too far-fetched. Durance agrees, "It does seem harsh to say that one of the big three (Ford) will not survive another decade intact, but if current trends continue then the market share and profits of the big three within the next 10 years will be extreme compared to today. As such, Detroit as a whole needs to work on a major comeback if all three companies are to compete effectively in future."

> **"The Big Three (Ford, GM and Chrylser) continue to suffer from unimpressive market demand in their key markets, and particularly that of the US, the largest vehicle market in the world."**
>
> **James Durance**
> *Research Manager*
> *World Markets Research Center*

Some see filing for Chapter 11 bankruptcies as a legitimate way to get out of the current mess, as many airlines and steel companies have done. However, given the history of automakers that would probably not be the chosen path. Instead, Ford chose a product-led revitalization plan, and GM decided to focus on the Chinese market. This proves that there are better ways to put the automakers on the growth track. The players are no novices and as Ford's India chief retorted to a news channel, they have gone through this before and probably will come out with flying colors. In its century long journey, Ford for one, would have learnt some important lessons in fighting such downturns.

DG Prasuna

Reference # 1-2003-08-10

GRASIM-L&T CEMENT

Changing equations

Another step towards consolidation of the Indian cement industry, signaling more mergers and acquisitions in future.

Cement is probably the only industry in India where the prices have been fluctuating very rapidly for the last few years in the absence of a proper pricing mechanism. A consolidation in this aspect, even though a reality had remained a distant possibility and the year 2003 had started with a good note for the cement industry in this regard. There were some remarkable consolidation efforts put in by the big players. The acquisition of the L&T's cement division by Grasim would not have come at a more appropriate point of time. It had triggered one more round of consolidation in the Indian cement industry. Post acquisition, the much sought after consolidation is clearly visible in terms of numbers, like Grasim now becoming the market leader in India in terms of cement production, manufacturing an annually estimated 30 million tonnes of cement. But, it is the pricing consolidation that is keeping analysts' fingers crossed.

With this acquisition, the three major players, i.e., GACL-ACC combine, Grasim and India Cements almost share 55% of the domestic cement production capacity among themselves. There are already rumors doing rounds that these three players could lobby together to put in place a proper price recovery mechanism for cement, thereby addressing the long wished pricing consolidation. All eyes are now on this much expected 'pricing consolidation' and the way it is going to happen in the highly fragmented Indian cement industry. The market had given the go ahead to the 'negotiated' acquisition deal between L&T's cement division and Grasim Cements, an Aditya Birla Group Company, where the later is buying out the former in a three-stage demerger process. The stocks of the two companies have risen sharply on the announcement of the verdict of L&T in favor of Grasim. "With this deal, the top four players would control close to 55% of the market share of Indian cement industry and the consolidation gains in terms of pricing would follow shortly," opines Manish Bhandari, Analyst (Cement Industry), HDFC Securities, Mumbai. He further adds, "Grasim is well poised to harness the upturn in the cement business." Does the deal augur well for the domestic cement industry? Yes, is the obvious answer from the industry analysts. "This deal augurs well for the domestic industry, where nearly 50% of capacities are fragmented which is in the hand of small players. While it will not be appropriate to speculate whether there will be a large-scale consolidation in the industry going forward, the Grasim-L&T deal will certainly provide a fillip to the same. In the Indian context, since regional disparities still exist as far as consolidation is concerned, we are likely to witness improvement in cement prices in regions where consolidation has occurred to a larger extent," observes The EquityMaster (www.equitymaster.com), an equity research firm based at Mumbai. But, does the consolidation on cards benefits all the players? Before dwelling into this, a look at how the deal that, until a month back was supposed to have reached a dead-end (in favor of Grasim) was worked out.

Fight for control

The fight for control of L&T's cement division by the Birla's through Grasim began way back in November 2001 when it had purchased Reliance's stake of 10.05%. Even though this was purely an investment decision, through this act Birla sent strong signals to both the industry and also to L&T, that it was keenly interested in consolidating its position by increasing its share of production. This also meant indications to L&T's top brass that Grasim had its eyes set on their cement division.

At the same time L&T, in its efforts to focus on its core business, on the advice of Boston Consulting

Group (BCG) had decided to shelve off its cement business and was looking for potential bidders. The obvious reason for the shelve off is the fact that the cement division is costing L&T lot of money that could be otherwise put into its rapidly growing engineering business. The cement division was not a strategic fit for L&T. BCG was even clearer in fixing a time-frame for the divestment of L&T's cement division. In its road map chalked out for restructuring L&T, it had advised the engineering company to bring in a strategic partner by early 2001 who would induce funds into its cement division so as to enable to put the cement business on a strong note. It further advised that L&T should, at any cost exit cement business latest by 2007.

Interestingly, since 2001 most of the foreign players were also considering entering the Indian cement industry through acquisitions. For all these interested multinationals, the only condition that L&T imposed is that the acquirer should merge its production capacities with L&T and that it would not handover any management control on its cement unit. This was a major impediment to all the prospective buyers, including the Birlas. At a time when no progress was being made, in August 2002, a private equity player, The Commonwealth Development Corporation (CDC) came forward with a proposal to buy small equity in L&T through investing in the Foreign Currency Convertible Bonds (FCCB) to be issued by the L&T, which have the option to get converted into domestic stock by the end of 2004. This is where Grasim thought that its interests in L&T's cement division are going to get deeply hampered and it immediately jumped into the field to stop L&T from issuing bonds to CDC. The lines were thus drawn for a fierce battle. Both Grasim and L&T stuck firmly to their stands and were marketing the merits of their own proposals. Grasim then tried to increase its 15% stake in L&T through open offer to L&T's shareholders, an act that had attracted severe criticism from L&T. It had even registered a case at Sebi against Grasim in early January 2003, for violating Sebi's norms on open offers. After a detailed enquiry Sebi had acquitted Grasim in March 2003 against any violations and cleared the roads for the proposed open offer.

Details of Investment by Grasim in L&T	
Investments in FY02 for 10.5% stake @ Rs. 306.6/share	7,661.0
Additional purchase from market by end of FY03	2,046.1
Purchase from market and open offer	557.9
Total	10,265
Total stake prior to announcement of deal 15.7% in L&T post open offer	
Details of transaction of deal	
Grasim stake in demerged entity	(12.6%)
Purchase of 8.5% from L&T @ 171.3	3,619.5
Purchase of 30% from open offer @ 171.3	12,773.0
Total investments till now	**26,657.0**
Sale of 15.7% stake back to L&T @ 120/share	4,690.0
Total deal size for 51.1%	**21,966.0**
Net shareholding in L&T cement company post open offer of the same – 51.1%	
Incremental cash outflow to Grasim	11,700.0

After months of distracted negotiations, finally in June both the companies came to a negotiated agreement, according to which, L&T would demerge its cement division by creating a new cement company christened Cemco. Grasim will acquire 51% stake in Cemco through a three-stage process which would come to a logical end by December 2003. Grasim will shed its stake in L&T in favor of L&T's employees trust.

Strategic benefits

Now coming to the earlier raised question, as to the benefits that the players involved in this deal would get; First, Grasim as a part of the deal should shell out Rs. 2,200 cr for acquiring 51% stake in Cemco, albeit in a phased manner. This is not supposed to be any problem for Grasim, given its strong financial position now. Bhandari says, "I strongly feel that this is a good deal for Grasim considering that it has bought huge cement assets ahead of a demand led price recovery. Moreover, this will not strain the cash flow or gearing of Grasim as the net outflow of Rs. 11,700 mn (see box: 'Details of Investment by Grasim in L&T') is close to one year of cash flow of Grasim." He further adds, "the deal would not disturb the interest expense and gearing of the company as the open offer and other formalities would take place in December 2003 and thus substantial cash flows would have been generated by then, hence having limited impact on financials." Grasim can cut costs and improve margins by means of synergizing the supply chains of both the companies. Equity Master says, "we believe that Grasim will benefit significantly on the logistics as well as procurement fronts. On the issue of procurement, the company is likely to enjoy greater bargaining power while procuring raw materials like coal and limestone. As far as logistics are concerned, the company is likely to see benefits in terms of costs saved during the transportation of cement to markets across the country."

With regards to L&T, it had got its pound of flesh as far as valuations are concerned (at about $79 per tonne cement as against previous value of $65) and it can now concentrate more on its revenue generating core business. L&T has

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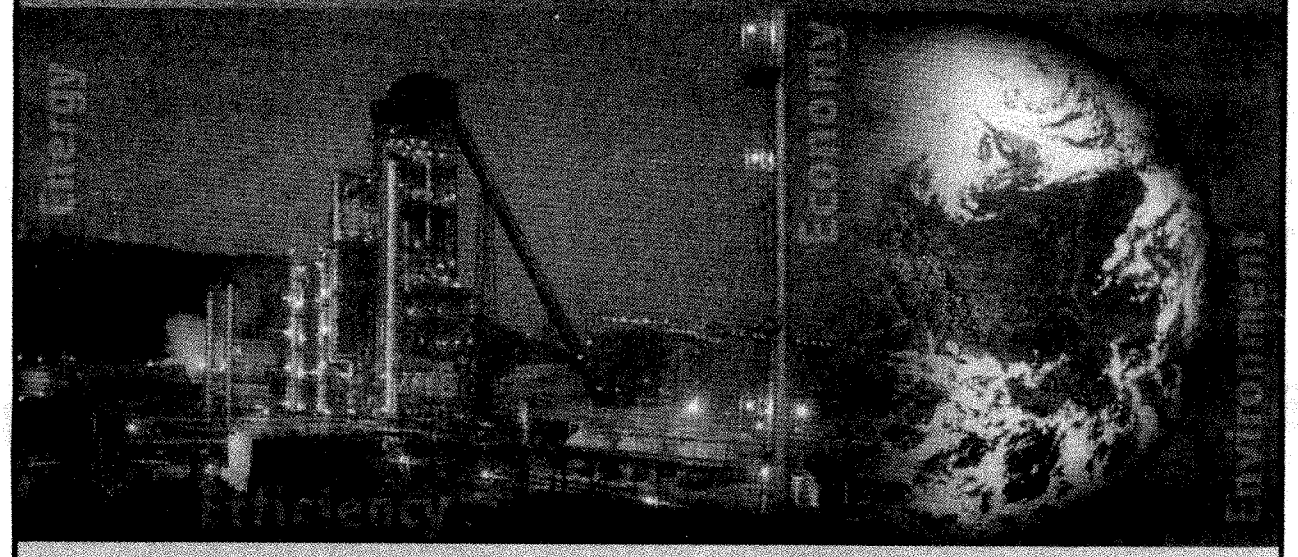

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ENERGY FOR EVER

to shed out of somewhere around Rs. 470 cr for Grasim's share of L&T, which it could easily manage through bank financing. But, regards to the valuation there is this opinion doing rounds in the markets, that a competitive bidding would have attracted much higher valuation for L&T rather than a negotiated settlement with Grasim. The Equity Master agrees with this thought. It opines, "A competitive bidding could have attracted a higher valuation for L&T's cement division. This is because even when CDC was in the fray it had reportedly offered a valuation of US$ 70 per tonne. We believe that if international cement companies had entered the fray, they may have given a better valuation for the L&T cement division. This deal has effectively blocked any chances of the same."

The shareholders of L&T will get eight shares of the new cement company Cemco for every 10 shares of L&T and they have the option to participate in the open offer being announced by Grasim later in the year, thus getting a fair exit option. "The deal is a good exit opportunity for shareholders of L&T" observes Bhandari. Echoing these views that the open offer period is the best time for L&T's shareholders to exit, points out Equity Master: "The L&T shareholders need to keep in mind the fact that the Rs. 171 per share that Grasim is likely to pay for the cement division is only during the open offer. This means that post open offer, price of Cemco shares will be determined by market forces. We believe that once listed, the price of Cemco shares may not rule at Rs. 171." It further adds, "there is still some ambiguity regarding Cemco's existence in the future." There are chances that Grasim might merge Cemco in itself, which is an issue the shareholders need to think about for the long-term. But this is not bad news for those who are willing to continue with L&T. There is optimism that L&T's EPC division might do well upon listing and the existing shareholders stand to benefit from their holding in the EPC division of L&T. "The EPC business shares post listing are likely to gain strength. An indication to this effect is the fact that other engineering companies are getting better valuations compared to L&T EPC division. This indicates that upon listing the L&T stock could correct towards the sector valuations," comments the Equity Master.

So all in all, the demerger of L&T's cement division is not at all a bad news for the players involved, i.e., Grasim, L&T and the shareholders.

MNCs – Cornered for the time being

"Concentrate on the small patches of the Indian cement market that are left over. And do not focus on the green field ventures." This is what appears to be the message the Grasim-L&T deal conveys to the multinational players like Lafarge, Cemex and Hocim. Agrees Bhandari. He says, "I think now players like Lafarge need to be satisfied by picking up small capacities across India." He further adds, "this again is a blessing in disguise for Indian cement producers as now even small capacities would get a decent exit for favor of multinationals. The final wave of consolidation would arrive faster than expected. Lafarage already has a large operation in eastern India, hence it would be looking to consolidate its share in that market and expand its reach in others. While this deal has made the prospect of further MNC acquisitions difficult, there are still smaller players in the market who have capacities in the range of 4-5 million tonnes. MNCs should still look at these companies as possible acquisition targets," suggests Equity Master.

The MNCs are now cornered to such a position that they are not in a position to leave India for strategic purposes, as India is still an important market and they cannot neglect it. The supply-demand imbalances still exist in India, especially in the Northeastern and the Western markets, and these foreign players are keen in operating these markets, which have not yet been tried by the Indian players.

Future: More consolidation activity!

All the activity that had been happening in the Indian cement industry is happening with the prime objective of consolidation, in terms of operators and also price. The only way that appears forward is that of increase in the number of consolidations. It was GACL-ACC, some time back and now it is Grasim-L&T. The major advantage that these two combines have is that they face no imminent threat from either Indian players or the multinationals at least until two to three years. But, despite these well-placed mergers, the cement industry is still fragmented. The chances of future mergers and acquisitions are restricted only to about 2-3 million capacities and what it implies is that the two major combines are well placed to take any step they feel would consolidate the industry. The likely effect of such a step is that the decisions regarding pricing and supply would be made in accordance with the market conditions and aspirations. Grasim has the first mover advantage in this regard, given its leadership position in the industry. Being in such an advantageous position, it is now up to Grasim to fulfill its dream of becoming the market leader and that of changing the dynamics of the domestic cement industry in favor of the consumers, by using its core strength, that of cement. As a final thought, the smaller capacity players in India should get ready to face some hostile takeover bids by the MNCs as they wait desperately to pounce back.

Ramakrishna Neti

Reference # 1-2003-08-11

The Future of Indian Rupee

Ever since the beginning of 2003, Indian Rupee (INR) has been showing signs of appreciation vis-à-vis the US dollar. Though the initial reaction to the appreciation was termed as a temporary phenomenon, the persistent appreciation of the INR during the last six months reveals a different story. Throughout the last decade, INR had been depreciating. In March 2001, dollar was at Rs. 26.40 and on May 2002, rupee reached the bottom at Rs. 49.08 to a dollar.

Owing to the fundamentals of the Indian economy and the bleak economic outlook for the US economy, INR has been appreciating steadily against the dollar. As a result of the positive aspects of the Indian economy outweighing the negative aspects—burgeoning foreign currency reserves, a steady pick-up in industrial growth, further liberalization of Indian economy and encouraging climate for investments, are acting behind the scenes. And for the first time in 25 years, the current account balance of payments is surplus. This transformation in the Indian economy is reflected in the appreciation of the rupee. On the other, the backdrop of a weak economic outlook and soft interest rates, dollar has been depreciating against all other major currencies. In fact, this reversal of trend has prompted many economists to conclude that dollar is losing its strong hold on the global economy.

While the appreciation of rupee is a feel good factor, rupee has been depreciating vis-à-vis other major currencies such as the euro and the yen. In fact, the steady appreciation of rupee can be attributed to the fact that dollar is depreciating against the euro and other major currencies. Till the time dollar continues to depreciate against other major currencies, rupee may continue to appreciate against the dollar. However, it cannot be deemed that rupee will continue to appreciate in future. It all depends on the recovery of US economy.

Whether rupee continues to appreciate against the dollar is still a debatable issue. To discuss this issue and the implications of the appreciation of rupee on the Indian economy and money supply situation, the factors contributing to appreciation, impact on businesses, how this trend will change the valuations vis-à-vis other major currencies and the future direction of the rupee and the role of RBI in this scenario, the *Analyst* invited Dr. Alok Ray, Professor of Economics, Indian Institute of Management, Calcutta; Bidisha Ganguly, Consultant, Economics and Corporate Research Group, Confederation of Indian Industry, New Delhi; Prof. N R Parasuraman, Professor in Finance, SDM Institute of Management Development, Mysore; Nagarajan M, Chief Economist, Indian Bankers Association; R K Somany, President, ASSOCHAM; and Anand Anchan, President, Global Trust Bank Ltd.

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Instead of depreciating at the rate of around 5% per annum in the recent years, Indian rupee has appreciated by about 4% in nominal terms against US dollar over the past 12 months. The general market expectation for the future has also changed from depreciation to further appreciation of rupee against dollar. This has got reflected in the forward premium on US dollar going below an annualized rate of 1%—an all-time low.

There are a number of factors that have influenced the appreciation of the rupee. In a floating exchange rate system, the movement in rupee-dollar exchange rate would reflect the demand-supply situation for US dollar against Indian rupee. So, the recent appreciation of rupee against US dollar is to be primarily explained by the supply of dollar exceeding its demand in the Indian foreign currency market. This is due to the current account surplus in India's balance of payments (the first time in 25 years), helped mainly by remittances from Indians abroad and export of services, particularly software exports. In addition, there has been a steady flow of foreign capital from abroad. The capital inflow has received a big boost, as the interest rate in India is 4 to 5% more than the interest rate in USA. In fact, rupee would have appreciated even more if the RBI had not created a demand for dollar by buying up dollars from the market and adding to its foreign exchange reserves.

It should be emphasized, however, that the current high level of accumulated reserves (which is a stock) have little direct effect on the daily movement in the exchange rate. The movement in the exchange rate is guided by the daily flow of demand and supply of a foreign currency vis-à-vis Indian rupee. One should also understand that though the rupee has been appreciating against dollar, it has been depreciating against other major currencies like euro. In other words, the dollar's fall is more of a global phenomenon due to the excess supply in global currency markets, thanks to the massive current account deficit of US (around 5% of US GDP). Moreover, foreigners (and Americans) are no longer keen to invest their money in the US with collapsing interest rates and stock markets. In 2003, US dollar has fallen by more than 9% against the euro, though only 0.6% against yen.

An overall balance of payments surplus or addition to foreign exchange reserves implies a rise in the domestic money supply as the suppliers of foreign exchange buy the domestic currency and add to the stock of money with banks. In fact, under a fractional reserve banking system, money supply may increase several times if the banks lend more money on the basis of the availability of excess cash reserves. Unless the RBI sterilizes this increase in money supply by open market operations (selling of government bonds to mop up the excess money from the banking system), the money supply would increase. Whether the increase in money supply would cause a reduction in interest rates or increase in investment or consumption expenditure or inflation would depend on many other factors like the existence of underutilized production capacity and expectations about the future.

On the business front, the rupee's rise against dollar would mean that Indian goods would be more expensive in dollar terms, which may reduce the sales abroad. Alternatively, if the dollar price of Indian goods is kept fixed (like consultancy fees of Indian software engineers), the corresponding rupee realization would be less. Either way, Indian export earnings may suffer. This has already affected the bottom lines and share prices of some of Indian software companies. The same may happen to other export industries, especially in the US market. On the import side, however, the rupee cost of oil and other goods (whose prices may be fixed in dollars) would fall which may help to keep inflation rate down. India's import-competing industries would also feel the pinch as they would have to compete with cheaper (in rupees) imports at home. However, industries (like transportation, healthcare, construction, hotels and tourism catering to Indian travelers) which use imported inputs like oil and equipment but do not face competition from cheaper imports while selling their outputs in the domestic economy should gain. In other words, such industries are able to buy some inputs at lower prices but their output price remains the same, which would inflate their profit margins. On the other hand, a lesser number of American tourists may come to India if the hotel tariffs are kept fixed in rupees rather than dollars when the rupee is appreciating against the dollar.

As already stated, the rupee's appreciation has so far been restricted to only against US dollar. Against other major currencies the rupee has been depreciating. In fact, based on the trade-weighted average of the currencies of India's five major economic partners, rupee depreciated by 5% in nominal terms and 3% in real terms (i.e., taking into account the difference in inflation rates in India and five other countries) over March-December 2002. So, Indian goods have not yet lost their international price competitiveness in all major markets.

Given the appreciation of rupee, the RBI should not intervene to stop the trend of rupee's appreciation

against US dollar. This is part of a global phenomenon reflecting the weakening of US dollar in the global market. However, RBI may intervene only to smoothen the excessive day-to-day fluctuations around the trend by buying or selling foreign exchange as required on a daily basis. Excessive fluctuations create instability in the market and may fuel speculative activities.

And finally with respect to the future direction of the rupee, no one can accurately predict the future direction of any currency. If they could, speculators would make billions of dollars. For example, the recent appreciation of rupee against dollar was largely unexpected. The future movement of rupee against US dollar would depend on many unpredictables like the timing of US recovery, the interest rate policy of Fed, the future investment climate in Europe vis-à-vis US, the political and economic developments in the Arab world. For instance, if OPEC at some point decides to fix its oil price in euro instead of US dollar, it may signal a shift of global economic power center from US to Europe with far-reaching implications for the exchange rate of US dollar against other currencies, including Indian rupee.

Bidisha Ganguly

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The appreciation of the rupee has upset the calculations of all those who believed that the rupee can only depreciate. It had become commonplace for all parties involved in future foreign exchange transactions to factor in a 5-6% annualized depreciation of the rupee. The recent appreciation will be beneficial for the development of the currency market in the long-term as two-way movements will get factored in. This is necessary for the successful development of the currency options market, which the RBI has recently introduced.

Two factors have been largely responsible for the appreciation of the rupee: One is the increase in India's balance of payments surplus. In 2002-03, India's balance of payments surplus increased to $17.0 bn compared to $11.8 bn in 2001-02 and $5.9 bn in 2000-01. This has been driven by

- **Rise in exports:** Exports grew at 18% in 2002-03 whereas they remained flat in the previous year.
- **Rise in invisible inflows:** Net inflows from services as well as transfers have increased significantly.
- As a result, the current account surplus has increased from $0.8 bn in 2001-02 to $3.7 bn in 2002-03. Earlier, India used to have a deficit on the current account.
- **Rise in capital account inflows:** This has increased despite a decline in both foreign investment and loans. There has been a large increase in inflows related to banking and other capital. We believe the former is largely due to cross-border interest rate arbitrage opportunities, given the appreciation of the rupee and the interest rate differential. The second reason is the weakness of the dollar in international markets. After a long period of dollar strength, the dollar came under pressure against most currencies in international markets, as the US economy weakened and capital inflows became inadequate to finance its burgeoning trade deficit. The appreciation of the rupee against the US dollar is thus in line with global currency movements.

The rupee is appreciating as the supply of dollars exceeds its demand in India. In order to prevent even greater appreciation, the RBI has to absorb some of the excess supply of dollars. When the RBI buys dollars in exchange for rupees, two things happen: The domestic money supply goes up and RBI's foreign currency reserves go up. If the RBI continues to pump up the domestic money supply in this way, it could be inflationary. Hence, the RBI sterilizes the impact of its forex market interventions by offsetting operations in the domestic debt market. It sells government securities in the market in order to absorb any excess liquidity in the market.

Currently, the RBI has been able to achieve a balance so that money supply has not increased drastically. In 2002-03, money supply increased by 15.2% well within the RBI's target range. However, there could be dangers to this process if continued for too long. Most importantly, excessive sales of G-secs by the RBI could drive down their price and put pressure on interest rates to increase. This then becomes a vicious cycle as higher interest rates would encourage interest rate arbitrage and put further pressure on the rupee to appreciate.

The RBI's policy is to let the market determine the direction of change but contain movements within a band. In today's markets, it would be foolhardy to move against the market. However, the RBI could try to influence the market. For example, it could allow interest rates to move down to a level where arbitrage would no longer be profitable. But the RBI continues to deny that any arbitrage is taking place while most market participants would dispute this. Even the data shows that foreign investment and medium to long-term debt related inflows are not buoyant. Instead, short-term capital is flowing in essentially to take advantage of the interest rate differential.

As a result of the appreciation, exporters suffer as their products become uncompetitive: Either they can maintain their dollar prices and accept lower realizations in terms of rupees or they can increase dollar prices to maintain their rupee

Table 1: India's Balance of Payments in US$ mn			
	2000-01	2001-02	2002-03
A. Current Account			
I. Merchandise	-14,370	-12,703	-12,474
II. Invisibles (a+b+c)	10,780	13,485	16,182
a. Services	2,478	4,577	6,206
of which: Software Services	5,750	6,884	8,863
b. Transfers	13,134	12,509	14,858
c. Income	-4,832	-3,601	-4,882
Total Current Account (I + II)	-3,590	782	3,708
B. Capital Account			
1. Foreign Investment	5,862	6,692	4,555
a. Foreign Direct Investment	3,272	4,741	3,611
b. Portfolio Investment	2,590	1,951	944
2. Loans	4,252	-1,350	-3,179
a. External Assistance	410	1,117	-2,460
b. Commercial Borrowings	3,737	-1,576	-1,698
c. Short-term to India	105	-891	979
3. Banking Capital	811	5,592	8,243
4. Rupee Debt Service	-617	-519	-474
5. Other Capital	-290	158	3,493
Total Capital Account (1 to 5)	10,018	10,573	12,638
C. Errors and Omissions	-572	402	634
D. Overall Balance (A+B+C)	5,856	11,757	16,980

realizations. Increasing prices is not likely to be acceptable in today's competitive world and hence exporters suffer lower margins when the rupee appreciates. The same is true of software companies that have substantial dollar earnings.

Another set of businesses that lose are the ones whose prices move according to import parity prices. This is true of a host of chemical and petrochemical products. The rupee price has to be reset downwards even when the dollar price remains constant. Importers of course gain from an appreciating currency, as imports become cheaper.

In reality, exports have not yet been significantly affected. Indian exports continue to do well. It is possible that the recent increase in productivity outweighs the negative impact of a rising currency and Indian manufacturers are able to remain competitive. However, this will vary across sectors: Exporters in sectors that have not been able to cut costs or increase productivity will be hurt by the currency appreciation.

Imports have increased on expected lines. Total imports grew 17.0% in 2002-03 up from 0.5% in the previous year while non-oil imports increased 13.3% in 2002-03 up from 5.3% in the previous year. During April-May 2003, non-oil imports increased sharply by 30.0%.

Although the rupee is appreciating against the dollar, its movement against other currencies is determined largely by their movements against the dollar. Where the third currency has appreciated more sharply against the dollar than the rupee, the rupee has depreciated against the third currency and vice versa. Thus, as shown in Table 2, the rupee has over the last year depreciated against the euro and pound sterling, remained almost steady against the yen and appreciated against the HK dollar.

The rupee has, in fact, appreciated against most other Asian currencies over the last year. The Chinese currency, for example, is fixed against the US dollar and has, therefore, depreciated against the rupee. Given that most of our competitors in the export market are from the Asian region, this is a cause for worry.

The rupee will continue to appreciate in the foreseeable future. There are two possibilities: The bubble could burst in a way that a lot of people get hurt or it could end smoothly:

- **Hard landing:** Sudden reversal of inflows possibly due to a general downgrading of emerging markets or a step taken by the Indian Government that is negatively perceived. Once the sentiment turns negative, there could be a rush to exit. Any unexpected depreciation of the rupee will hurt a lot of businesses that have not taken cover. Importers and foreign debt holders especially will have to reassess their investment decisions.
- **Soft landing:** The rupee slowly climbs down, probably as the dollar stabilizes in international markets. The RBI can aid the process by maintaining a soft bias on interest rates.

Table 2					
	INR/ US Dollar	INR/ Pound sterling	INR/Euro	INR/ 100 Yen	INR/ HK dollar
June 2002	48.97	72.57	46.74	39.65	6.27
June 2003	46.72	77.60	54.60	39.52	5.98
% change	-4.6%	6.9%	16.8%	-0.3%	-4.6%

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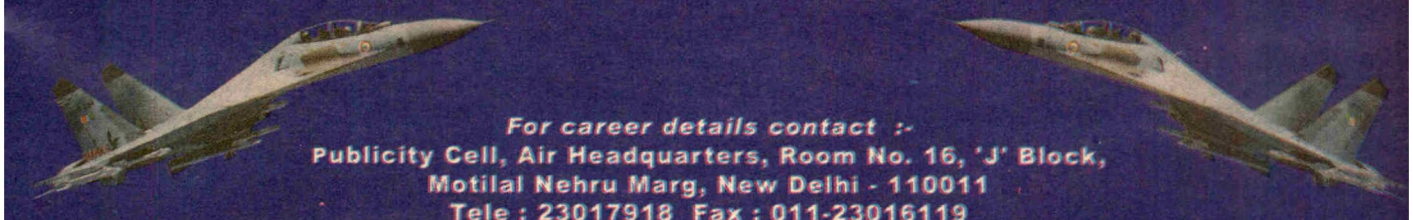

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The Indian rupee has strengthened to Rs. 46.39 now. There has been consistent inflow of spot money. The overall expectation in the market is for the rupee to appreciate further.

One reason attributed for the rupee's steady gain has been the flow of foreign funds to the Indian bond and equity markets. This has resulted in the recent spurt in the bond and equity prices and corresponding fall in the yield of government bonds.

The appreciation of the rupee has a lot to do with the unprecedented high levels of reserves that we now have. The reserves have burgeoned partly because of interest rate expectations and the generally perceived improvement in the investment climate in India now. Further, the steady fall of the forward premium has been made use of by importers and other companies with foreign currency loans and they have reduced their unhedged positions.

The impact of the steady appreciation on the economy and money supply situation cannot be conclusive unless this is sustained for a longer period of time. The Indian economy has been growing but there have been quite a number of uncertainties—on the political front, on the border situation and also on the agricultural outlook with the indifferent monsoon that is forecast. True appreciation of any currency can be ultimately based only on domestic strengths and not merely on extraneous considerations. The present appreciation of the Indian rupee against the dollar has more to do with a combination of international factors like the US economic problems, the Iraq war, inflow of NRI and foreign investment funds etc.

As per exchange rate parity principles, the cross currency rates have to maintain the balance as otherwise international arbitrage becomes possible. If there is an imbalance for any length of time, operators in foreign currency will be able to gain from arbitrage and this action will bring about the parity. From the Indian perspective, what should come, as a relief is the high level of foreign exchange reserves available.

Normally, central banks intervene when there is an appreciation or depreciation of the currency. The RBI can afford to take a wait and watch policy for some time and see the impact on the Indian economy of the changes in rates. Although the rupee has been appreciating by and large, we did see a fall by over 20 ps in a week towards the end of May this year. While the reserves are a source of comfort, RBI has a definite role in framing a good monetary policy that would sail us through.

The future direction has a lot to do with what happens to the dollar. There is an overall expectation that the US economy is improving. Although the US' expectation of a 3% growth in the economy may be optimistic, it is certainly likely to grow faster than the European economy. The target rate cut of 0.25% recently brought about appears to be the right balance to spur the economy and further outflow of investments from the US is unlikely. So the appreciation of the rupee will have to lose momentum soon. It is then a question of improving the economic fundamentals.

Nagarajan M

Chief Economist
Indian Bankers Association

The appreciation of rupee in the recent past is a natural outcome given the prolonged weakness of the US economy and relatively better performance of the Indian economy. Besides, the Indian authorities have taken several affirmative actions and implemented policy measures which have the potential to augment India's foreign exchange reserves. Hence, the appreciation only reflects the inherent strength of the Indian economy and the success of the policy.

Most of the people think that the appreciation of the rupee is on account of the forex reserves. I would think the other way: Foreign Exchange Reserves (FER) are more because of the rupee appreciation. According to the RBI, over one-sixth of the increase in FER during 2002-03 was due to the change in the value of the Indian rupee.

The appreciation could be mainly on account of four factors. First, the US economy has been limping for a very long time. Its rate of growth has been virtually negligible. Hence, the rate of return on assets (particularly financial assets) has been very much low. On the other hand, the elderly population has been growing and their income from investments has almost disappeared following the steep reduction in the interest rates. Consequently, investible resources from the US are flowing outward in search of higher rate of return. The Indian market is one such place which offers a better rate. In this context, it is useful to note the recent quantum jump in the inflows of foreign funds, effected by the foreign institutional investors in the Indian financial markets. Secondly, there is a wide gap in the interest rates prevailing in India and the US. This provides enormous arbitrage opportunities to the investors. Of course, the RBI has been maintaining that this is not a real issue, but the contention is debatable. Thirdly, after 9/11, the US authorities are more concerned about money laundering. Now, funds could not be parked abroad for a long time without valid reason and without raising the attention of the authorities. Lastly, foreign exchange receivers in India (e.g.,

exporters) now feel that the rupee would only appreciate in the near future. Hence, if they are to realize a better rate of exchange, it is in their interest to speed up repatriating export proceeds. In this context, it is pertinent to note that the level of 'Other Banking Capital' flows under the capital account in the balance of payment statistics has been abnormally increasing and that the RBI has attributed this to the leads and lags in the realization of export proceeds.

The appreciation will have a positive impact on the economy. Our imports will become cheaper. This would enable us to augment our productive capacity through larger imports of capital, raw materials, and accessories. If needed, we could also import consumables like edible oils. Such augmentation would help control the prices. In the medium and long run, domestic entreprenuers would also become efficient. That would help us to emerge as an efficient economy. In this sense, the appreciation is a stimulant of economic growth in India.

As for money supply, the RBI will have a difficult time. Interest rate differential and the appreciation will continue to attract large inflows. This would lead to an unacceptable increase in money supply. The RBI will have to sterilize the flows through open market operations. In this regard, it is likely to face difficulties because its holding of marketable government securities are steadily but surely dwindling. There is a distinct possibility of the RBI losing its complete hold on determining the quantum of money supply.

As a result of the appreciation, the import business is likely to thrive. Cheap imports will generate higher demand. This could be in the commercial sector (e.g., capital goods, etc.) or consumption sector (e.g., body care products). In either case, the import business is likely to benefit.

As for export-oriented businesses, it is rather difficult to predict with certainty. Surely, their rupee realization will be less. But, this will only reduce their profit margin. Besides, the foreign demand is, by and large, unresponsive to small changes in the rates: The main considerations are quality and timely delivery. If the export businesses meet these criteria, I do not see any adverse effect even in the short-term. In the long run, however, the exporters will have to become competitive.

The US dollar has been declining against not only the Indian rupee but also all other major currencies especially the euro, DM, yen, and pound-sterling. In contrast, the Indian rupee has been depreciating against these currencies. This is because the crossing of the exchange rate. This trend will continue since the method of fixing the exchange rate will also continue.

According to available evidence, the RBI does not target any exchange rate. Its primary objective is to manage volatility with no fixed rate. The rate is determined by the market. There could also be temporary mismatch between demand and supply of foreign exchange due to lump sum demand or large supply. This might assume some seriousness at some times because of the underdeveloped exchange market. In those situations, the RBI will intervene to contain undue volatility. This policy and practice will continue in the future also.

R K Somany

President
ASSOCHAM

The recent strengthening of the rupee against the dollar is a sign of growing confidence in the rupee. The fact that the economy is no longer constrained by dollars due to the build up of huge foreign exchange reserves are also encouraging exporters to bring back dollar earnings by over-invoicing (citing a value that is greater) their receipts. Dollar reserves are also building up due to the growing surplus in the current account and increasing growth in invisible earnings. The weakness in the US economy along with the growth in demand for the rupee due to FII demand and surplus in the current account has led to a fall in the value of the dollar.

The appreciation of the rupee is however, not an unmixed blessing. The increase in the exchange value of the rupee has implied costlier exports and cheap imports. The fact that import bills are going down especially when about 30% of the imports comprise of the highly inelastic fuel demand is good news but the exporters are feeling the pinch. However, quality, efficiency in delivery and trade policies play a significant role in export promotion and, one must concentrate on these factors since we ultimately, have to compete with China.

We have already discussed the causes of appreciation of the Indian rupee. The build up of forex reserves is definitely a factor but one must not forget the weakness of the dollar itself in the international economy. The recessionary tendency in the US economy has contributed greatly to the fall in its value vis-à-vis the major currencies of the world.

The appreciation of the rupee will undoubtedly impact the Indian economy and money supply situation. Cheaper imports are definitely leading to forex savings. The exporters are facing great difficulty in keeping their margin intact but still, there is no information of any major impact on export earnings. The RBI is exercising great professionalism in managing the scene. It is using its resources to prevent the rupee from appreciating further. The slow and steady upward movement is due to the buying of dollars by the RBI and subsequent release of Indian rupees. To prevent the inflationary tendencies from growing, the RBI

has undertaken sterilization exercise but, banks are already holding more government bonds than required by the normal SLR norms. There is excess liquidity in the system but inflation is still under control. The excess capital can be used to benefit the Indian economy by making judicious and productive investments.

Indian businesses have much to gain from this appreciation in the rupee. Taking advantage of the huge foreign exchange reserves, Indian companies are borrowing dollars from the international debt markets. Indian companies are taking full advantage of the falling forward premia rates and low global interest rates to finance their investments, and in some cases have made foreign acquisitions. This has greatly reduced the investment costs of these companies. Indian mutual funds have been allowed to invest $1 bn in companies listed overseas that have at least 10% holding in a locally listed company. Even individuals have been allowed to invest in such overseas companies, with some restrictions. Companies have been permitted to acquire immovable property overseas for business and staff housing purposes.

Import-oriented businesses which re-export are doing well since the fall in prices of intermediates mean increasing price competitiveness. Regarding export-oriented businesses, the margins are under pressure but there is no cause for panic on the earnings front as yet. There is a bit of apprehension about what will happen if the rupee breaches the 46 mark but once again it is difficult to see which way the rupee will be headed once it reaches that mark. Going by the fundamentals, the rupee should rise further but like all markets, speculators have the final say. If they can team up to generate enough demand for dollars, the rupee may start a southward run.

Over the period from April 2002 to April 2003, the rupee has gained 3.4% against the dollar. Simultaneously, it has depreciated 16% against the euro, 5.5% against the sterling and 5.4% against the yen. The overall change in the valuation of the rupee is captured by the Real Effective Exchange Rate (REER). The REER of the rupee is a trade weighted average of the exchange rates vis-à-vis five major currencies. It has hence shown very minor changes.

The RBI is having a tightrope walk to do but it has managed proceedings brilliantly. On the one hand it has tried to keep a good leash on the rupee so that exports remain competitive and on the other hand it has kept inflation under check. It has to continue the job of maintaining this delicate balance.

We have seen that in spite of the negative ratings by the various international credit rating agencies, FII and FDI money continues to flow into the country. This is primarily due to the rate of return on investments in India, which continue to exceed international rates. Going by this, the good monsoons and the growth in the IIP, the demand for the rupee should continue to rise through the FII route. But once again with currency markets, making concrete predictions is difficult.

Anand Anchan

President
Global Trust Bank Ltd.

The appreciation of the Indian rupee should be seen in the context of the overall appreciation of all Asian currencies vis-à-vis the US dollar. It is not just the rupee that has derived the benefit of the falling dollar but a host of other currencies too have benefitted. As such, it is easier to look at the rupee 'appreciation' in terms of a more global dollar weakness that has been witnessed in the recent past. The Federal Reserve's softer bias towards interest rate will continue as far as the US economy is not showing any signs of recovery. Thus, interest-rate differential between India and US is also supporting the movement of capital into the country. Various other factors like higher growth in the economy, higher interest rate, a positive political scenario etc., are favoring the rupee appreciation. Even if we value the rupee on trade weighted basis, the real effective exchange rate is also in favor of rupee appreciation. However, the cross-border flows in the short and medium-term can reverse, if the US economy improves leading to a sudden trend reversal.

Given the falling interest rate scenario over the last two years, dollar funds have been steadily moving out of US investments into more viable investment options in Asia. India, with a sturdy GDP growth rate of over 5%, offers excellent opportunities for investment. A stable coalition government, a liberalized economy, freeing regulatory environment are the contributory factors that have caused a steady flow of dollars into the country. A vibrant stock market and relatively higher rupee interest rates have also contributed to the flows. This apart, a dominant sale of forward dollars by exporters and a relative lack of demand for forward dollars by importers is another reason for the appreciation of the rupee. It may be noted here that the constant inflows have contributed to the build up of reserves and as reserves keep growing, confidence in the rupee also improves.

A steady appreciation of the rupee would definitely have an impact on the interest of the exporters, who have traditionally benefitted from the depreciation of the rupee. They would now have to look at other options in order to maintain their export competitiveness. While appreciation of the rupee could result in lower export competitiveness and hence lower exports in the short run, in the long run, lower realizations will bring in higher efficiency, increased

competitiveness and better management of resources. We have seen traditional gem and jewelry exporters looking at domestic markets to increase sales. Increased pressure on the exporters hence results in them seeking newer markets to expand. On the other hand, an appreciating rupee can stimulate import demand if other economic conditions are conducive. Ideally in an upturn in the economy, a strong rupee would be a good stimulant for the imports to pick-up. An appreciating rupee per se should not have much impact on the money supply unless of course the RBI continues to buy dollars to smoothen the process of rupee appreciation. This would be adding to the money supply and would lead to some sterilizing operations to counter the liquidity build up in the system.

The biggest advantage of two-way movement in currency rates is the adoption of better risk management techniques by corporates. Strong rupee would help reduce hedge cost for the importers. As part of the WTO negotiations, India would anyway have to reduce trade barriers by rationalization of tariffs. A strong rupee would benefit other countries to gain market share at the cost of domestic players. A steady growth in the economy will also attract capital goods import. With inflation being under control interest rates have come down drastically leading to lower production cost. The exporters, on the other hand, are exploiting ways of improving their business by focusing more on quality, economies of scale etc. In the longer run all this will lead to a better adoption to changing environment.

Movement of US dollar versus other majors depends on the economic fundamentals between those countries. The US dollar has depreciated against most currencies. However, the rate of depreciation against other major currencies like euro has been higher than that against the rupee. The valuations are a function of the rupee against he dollar and dollar against any other currency. If pound appreciates faster against the dollar, we may see the rupee depreciate against the pound.

The model which other Asian nations adopt for their currency is also going to be vital in the coming years. The Chinese currency is undervalued and artificially pegged to the dollar within a band. The Malaysian currency is also pegged. These artificial levels of competitor nations will be of more concern than the volatility of market-driven majors.

In the current scenario, Central Bank's role is to see that interest rate/currency rate movements are smoothened to help the economy tide over such moves. Had RBI not been intervening in the currency markets, the rupee would have appreciated drastically thereby impacting exporters adversely. The rupee has during the last one year appreciated by a meager 4.90%, which has helped the exporters to slowly adjust themselves by changing their business models. They have focused on efficiency factors, invested in better machinery, concentrated on better marketing, increased volumes etc. RBI has to monitor the currency movement closely to see that the economy is not affected adversely during the transition. The Central Bank will continue to moderate the volatility in the markets for the greater good of the economy. Proactive steps like restricting the FII limit of investments in debt markets to US$ 1 bn to avoid hot money flowing in and encouraging SBI to float foreign currency bonds to retain a part of RIBs (Resurgent India Bonds) are pro-economy in the long run.

In the past year the export growth has been robust. There has been a growth of 18% in exports in 2002-03 over 2001-02. We expect the growth to continue although the rate of growth would come down on account of the high base of last year. Over a third of the export growth is coming from price insensitive sectors like high technology and pharmaceuticals. There is an increase in tourist arrivals and greater service exports on account of software and BPO. The SARS scare in other Asian countries will also benefit sectors like textiles. Imports have grown by 17% with non-oil imports growing by 13.3% and oil by 26.7% in 2002-03. The first few months of the current year show a near 40% growth in non-oil import indicating a high level of activity in the domestic sector. FII/FDI flows have been higher in the current fiscal. Interest rate domestically offers arbitrage for NRIs and there will be flows on that account too. Similarly to avoid hot money flowing in through NRI deposit route, RBI has capped the interest payable on fresh repatriable NRE deposit for one to three years by 250 basis points over the LIBOR/SWAP rates for US dollar of corresponding maturity, effective from July 17, 2003. All these measures are aimed at moderating the currency movements.

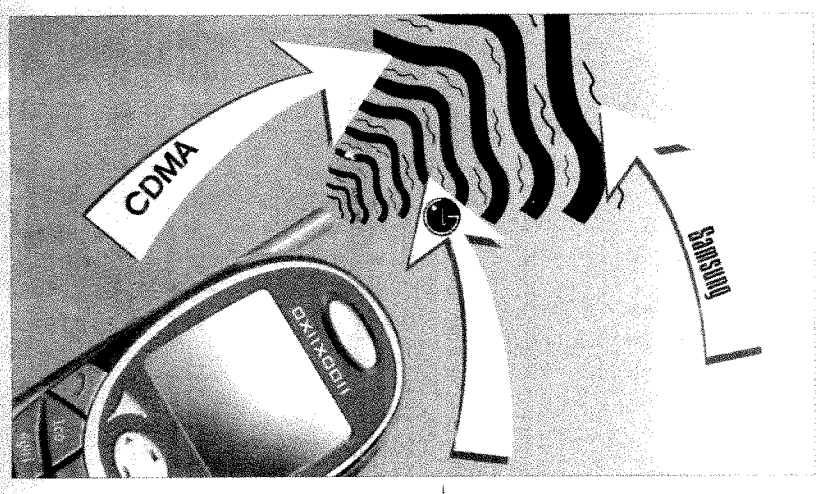
Given the positive factors for growth and flows, we expect the rupee to appreciate further. In a strong rupee environment also the growth factors have been robust. This shows that the economy is able to benefit from the positives of a strong currency. As our economy grows in strength, this capacity to improve becomes stronger and as such the currency minders will not be overly concerned with rupee appreciation.

The views expressed are the personal views of the participants and not necessarily of the organizations they represent.

NOKIA'S SQUEEZE

Between CDMA and rivals

From lumber to rubber to cellphones Nokia's journey so far is nothing less than spectacular. Given the competitive pressures and the rapid rise of CDMA, its future seems to be even more impressive.



Nokia's is a classic success story. Its evolution from a lumber company to a conglomerate engaged in manufacturing rubber, cable and televisions, to being a world renowned telecom giant is unmatched in the business landscape.

But then like every fairy tale, Nokia too has its share of difficulties because of its growing rivals like Samsung and the technology standard—CDMA, which is gaining momentum in North America as well as in Asia. Samsung, which occupies the No. 3 position as per the global market share, and LG along with its American rival Motorola, which continues to be at No. 2, are inching into Nokia's share. And, more worrisome is the fact that Nokia has less than 10% share, in the rapidly growing CDMA market, which is dominated by Samsung and LG.

Arrested growth

Over the years, the company has moved towards the 'mobile' vision, of being the world's largest cellphone maker with about 40% of global market share—a figure that is more than the combined share of its next three competitors. Nokia's efficient manufacturing and distribution that allow it to quickly churn out products at a low cost, has seen its profits rise over the years. It outpaced Motorola in 1998 to become the most profitable company largely due to its cost efficiency and economies of scale. Since then, the company consistently outperformed its competitors and grabbed the market share in the world markets. It has about 38% share of the global mobile phone market—a figure it expects to raise in the second quarter of this year.

Nokia's problems reflect the problems of the telecommunications industry as a whole. The industry has been reeling under the burden of massive debts accumulated as a result of heavy and unyielding investments in third generation (3G) mobile services and mindless acquisitions. On top of that the demand side of the equation is equally grim.

Even though, in the first quarter of this year, Nokia clocked a 13% increase in profits, to the tune of €977 mn ($1.07 bn) in the first three months, due to surging sales of its Oyj division, and all news at this Finnish conglomerate is not so good. It has slashed around 1,800 jobs and closed down some projects to counter the losses in its wireless network equipment business. The division that posted an operating loss of €127 mn, compared to a profit of €146 mn, is the sour spot of Nokia's businesses. The division has been severely hit as mobile phone carriers have cut spending on telecommunications equipment after a period of huge investments for acquisitions and getting new licenses. As a result of the slump in demand, the overall sales of the division was also lower at €6.7 bn as against €7 bn a year ago. This problem is common to all equipment makers, but Nokia is particularly hurt because the losses at the equipment division are compounded by the fall in mobile phone shipments. The mobile handset market is nearing satiation—after the roaring 1990s' double-digit growth figures. Although in 2002 the shipments grew and are expected to grow further this year, the rate of growth is negligible.

Sated Europe

Even in Europe, where Nokia gets around 54% of its sales, a long-drawn out slump in wireless network equipment business has resulted in severe losses for the company. On top of that the European markets are almost saturated, as penetration levels in some countries are higher than 75%, leading to a sharp decline in demand for handsets.

Sales at Nokia's home market Finland are particularly worrying. Table 1 shows, over the years the sales have been declining due to

Table 1: Nokia's Performance					
	2002	2001	2000	1999	1998
Net sales by business group, EURm					
Nokia Mobile Phones	23,211	23,158	21,887	13,182	8,070
Nokia Networks	6,539	7,534	7,714	5,673	4,390
Nokia Ventures Organization	459	585	854	415	–
Discontinued Operations[1]	–	–	–	580	1,014
Inter-business group eliminations	–193	–86	–79	–78	–148
Nokia Group	30,016	31,191	30,376	19,772	13,326
Net sales by market area, EURm					
Europe	16,111	15,330	15,554	10,614	7,673
of which Finland	353	453	494	479	465
Americas	6,541	7,891	7,708	4,909	2,815
Asia-Pacific	7,364	7,970	7,114	4,249	2,838
Nokia Group	30,016	31,191	30,376	19,772	13,326
[1] Discontinued Operations include discontinued and divested operations as follows: Display Products 1998-1999.					
Source: www.nokia.com					

high penetration levels in this small country. In the coming nears, they are likely to decline further, and the only way sales can happen is through replacement or upgradation.

While the European markets are moving at a snail's pace, in the growing markets of US and Asia, Samsung and LG are outpacing Nokia.

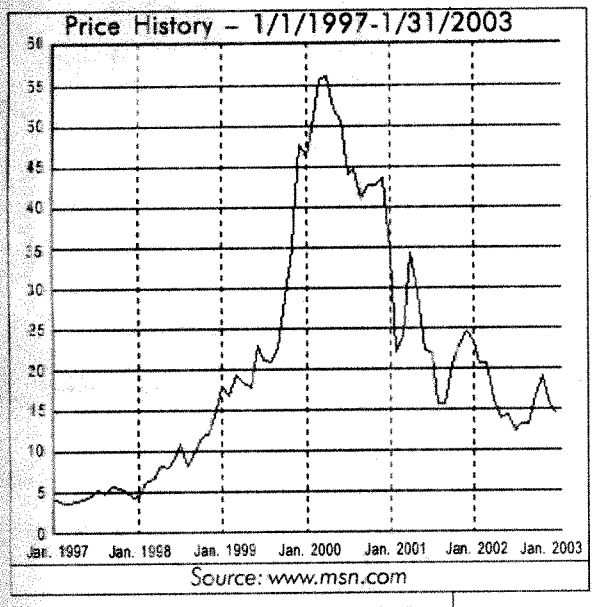
Threat from the East

Korean players, Samsung and LG have been growing enviably in US and Asian markets with a strong product line and aggressive marketing. In fact, Samsung has made to the No. 3 position in the global share in just two years. While Samsung's sales grew by about 34% in the past 12 months, Nokia could only manage to grow by 21%. In that period Motorola and Ericsson registered sales declines but all the more, their threat to Nokia cannot be underestimated.

Motorola continues to be No. 2 in terms of global share and after its turnaround in 2002, it has become rather aggressive. Nokia has another nagging problem. So far as Ericsson is concerned, its tie-up with Sony, which is currently not doing well, may pose a threat in the future. Apart from the handset business Ericsson is also a player in the equipment market (along with Lucent Technologies and Nortel Networks), Nokia might just have to keep a keen eye on this Swedish giant.

The Finnish firm is going through testing times—the European markets aren't growing, in the US markets it is faced with Koreans and in Asia, especially China, the local handset sellers are boring into its business. In Mainland China, for instance, Nokia is the leading handset seller. But the increasing competitive pressures from the local sellers like TCL Holdings and Ningbo Bird have badly hurt Nokia. Industry reports say that these local players have garnered as much as 30% share in the first quarter of this year. Just four years ago, these players were relatively unknown and today they are bruising Nokia by driving down handset prices. Dana Tardelli, Research Director, Communication Services at the Boston-based Aberdeen says, "If China and India are the growth sectors of the industry, Nokia must accommodate these developing markets with lower-end handsets. Instead they are packing more functionality, and therefore costs, into the devices. Motorola, LG, and Samsung are taking a more balanced approach making a serious bid for both high and low end handset markets."

Table 2: Nokia's Success Story					
	2002	2001	2000	1999	1998
Profit and loss account, EURm					
Net sales	30,016	31,191	30,376	19,772	13,326
Cost and expenses	–25,236	–27,829	–24,600	–15,864	–10,837
Operating profit	4,780	3,362	5,776	3,908	2,489
Share of results of associated companies	–19	–12	–16	–5	6
Financial income and expenses	156	125	102	–58	–39
Profit before tax and minority interests	4,917	3,475	5,862	3,845	2,456
Tax	–1,484	–1,192	–1,784	–1,189	–737
Minority interests	–52	–83	–140	–79	–39
Profit from ordinary activities before cumulative effect of change in accounting policies	3,381	2,200	3,938	2,577	1,680
Cumulative prior year effect (after tax) of change in accounting policies	–	–	–	–	70
Net profit	3,381	2,200	3,938	2,577	1,750
Source: www.nokia.com					



Then there is the issue of the mobile standards. The European and US markets have GSM as the entrenched standard, where Nokia is pretty strong, but in the emerging markets CDMA is more popular. In fact, CDMA is also being increasingly preferred in US.

The standards game

Nokia has a mere 10% share in the CDMA market and it is making an all out effort to boost it. It has even decided to license the technology to chip making firms like Texas Instruments and STMicroelectronics.

CDMA is growing faster than any other mobile phone standards. Nearly 20% of the total number of phones sold worldwide this year would be based on CDMA. Moreover, in Japan, US and Korea, replacement rates of phones are in favor of CDMA.

Nokia started making CDMA chips from 1997 but till recently they were low end, supporting only a few functions. But now it has packed up more power that enables the support of a larger array of features. Thus, it is ready to launch a CDMA phone with a full-color display and MMS, called the Nokia 6585, by this year-end. Tardelli feels that "CDMA, despite its growth rate, represents a small portion of the global marketplace. Nokia has recognized this growth and has put in resources to get the speed. The company will tap some of this revenue stream moving ahead, but must acknowledge that the business rules of CDMA are very different from GSM. There is much less 'openness' and consensus with CDMA. Instead, it is about speed to deployment and speed to revenues." He adds that if Nokia can accommodate these customer requirements, the company can stay ahead of the pack.

Nokia seems to be inviting too much of competition—by playing on all fronts of the telecom business, it might just be spreading itself too thin for its own good. Nokia could borrow a leaf out of Motorola's book. As part of its efforts to trim down, so as to stay competitive, it has discontinued producing its own chips and is buying from Qualcomm. This way it is poised to benefit on the cost front, as Qualcomm enjoys greater economies of scale.

Such a strategy would make much more sense, as the standards business is very fleeting. Even before the full-fledged spread of CDMA, the next generation standard called WCDMA (Wide Band Code Division Multiplexed Access) is making rapid inroads. It is estimated that the market for CDMA would grow from about a 2 million chips in 2003 to nearly 40 million in 2007. So, when the next generation of standard technology makes its way into the market, Nokia would have to change its manufacturing of chips as per the technology. In the process, it might lose out on competitors that outsource chips. The strategy is all the more sensible as Qualcomm has been devoting a third of its R&D budget into WCDMA.

Then again, there is Samsung, which recently announced that it would rely more on its own CDMA chips, for which it devoted several years of development. But, for Samsung, which is famous for putting its bets on everything, it might be okay. It has licensed almost everything—Symbian, Microsoft licenses, and has even launched phones using the Palm operating system.

But for Nokia, Samsung might not be a good model to emulate. For one, though it is like Nokia in being a conglomerate, its way of doing business with everybody and anybody might not bode well for Nokia to imitate. The Korean wave may turn out to be as elusive as the Japanese one. So, Nokia would do good to develop its own strategy based on the opportunities and its Finnish knack for rosily packed technology.

Does the future ring?

Nokia is well on the path—to beat the slump, it has launched a slew of new products such as the hugely popular camera phone 3650 and a costlier 7650. These phones with a built-in digital camera have driven the demand for wireless Multimedia Messaging Services (MMS), capable of transmitting voice, e-mail and photos. Nokia has also diversified its product line into nine market segments, which include business devices, games and entertainment devices, and entry-level phones aimed at the developing markets. And, despite the slump, these models were hugely successful, proving the strength of innovation.

Till now, Nokia has been steady at the helm, but in the days to come, keeping that position might be harder. That doesn't mean that it should stop innovating and launching new products because they are the cure to the malaise of the slump in demand especially because it is caught between nimble rivals and emerging technology. Thus, Nokia, like its MMS ads, should not be the dinosaur—too huge, flabby and inflexible for its own good.

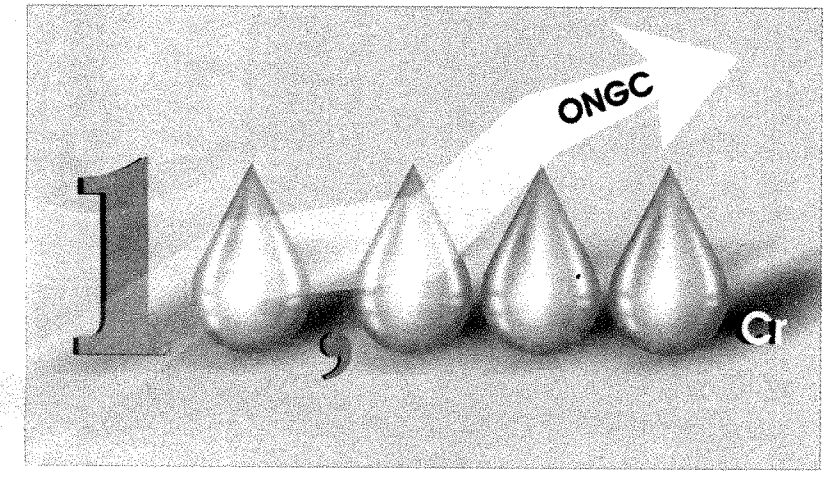
CSV Ratna

Reference # 1-2003-08-12

ONGC

Reaping the oil fortunes

A furtive turnaround program carried over a period of two years has enabled ONGC to become the first company in India to report a net profit of above Rs. 10,000 cr.



ONGC, India's largest upstream oil and natural gas producing company is successfully leading the country's efforts to become self-reliant in oil production, thereby ensuring oil security to India (in the background of events like the Iraq war) which is bound to become one of the world's largest oil consuming country by 2010. Even now, India stands one among the top oil consuming countries and imports almost 70% of its oil requirements from the Middle East. If it is not for the efforts put in by ONGC Videsh, a subsidiary of the parent company which is enforced to operate abroad by not just entering into equity partnerships with other oil companies, but operating oil fields by its own in foreign countries, India might have been still left far behind in oil exploration and production. Other oil majors like Reliance and Indian Oil are complementing these efforts towards attaining complete oil security for India as envisioned in the India Hydrocarbons Vision Document-2025 formulated by the Government of India. The journey manifesting the phenomenal growth of ONGC to become one of the top wealth creating companies in India from that of an average performer in the last decade (with diminishing crude production and dwindling reserves every year) is indeed interesting. The turnaround as it happened was not a cakewalk. Addressing to its problems one after the other in a phased manner within a stipulated time period worked wonders for the company. The major problems it faced include:

- Over exploitation of the offshore Bombay High Oilfields for gas exploration in violation of the standard acceptable limits, which resulted in decline of resources.
- Lack of investments in oilfields both within the country and also outside for oil exploration and production, thereby affecting the long-term sustainability of the company.
- The deregulation of the Indian petrochemicals industry as a result of which the company had to face tremendous competition.
- Lack of efficient and effective top-management leadership.

The turnaround saga

Restructuring and vertical integration form the core elements of the turnaround program for ONGC, which was initiated by its Chairman Subir Raha. In his opinion, as reported in *Business Today* (April 13, 2003), ONGC had reached a stage where in order to sustain in the long-term, the company had to grow hard, if not fall by the way side. In addition, the measures like increasing the capacity of oil reserves, entering into strategic partnerships with companies abroad and augmenting its recovery levels were also taken up simultaneously. The targets for increasing the oil reserves is 12 billion tonnes by 2020 as against 5 billion now. With regard to enhancing its recovery levels the target set is 40% as against 26% now. For this fiscal the target for crude oil production is set at 26.39 million tonnes as against 26 million tonnes the previous year.

As a part of the vertical integration efforts, ONGC had acquired the Mangalore Refinery and Petrochemicals Limited (MRPL), which marked its entry into the oil industry's downstream activities like refining. The objective of the whole vertical integration process is to withstand seasonal business fluctuations, so that a healthy financial status is maintained through all the business cycles. This also has a financial presumption. The idea is that by vertically integrating, ONGC would be able to improve its P/E ratio considerably so that when the company comes for disinvestment, it would become a favorable stock for investors. Slashing operational costs resulted

in saving a lot of money which is reinvested in oil exploration and production activities in India and abroad. The company has plans to open retail outlet networks across the country.

Given its strategic importance in the Indian petrochemicals industry, ONGC is making fresh infusion of funds into its oil exploration bases all over India. As a part of this, it started renovating the Bombay High oilfields whose output has been coming down year after year. Nearly Rs. 9,000 cr were put for renovating these oilfields and the results showcasing their bettered performances are already out. Crude oil production at Bombay High are now at their five years best, operating at around three lakh barrels per day. Encouraged by this performance, ONGC is now concentrating on other oil wells with the aim that every oil well functions at its best performance levels. The company has ambitious plans for its gas exploration and production activities in spite of the fact that it is now going surplus in maintaining the gas reserves. To achieve these ambitious goals the company had stepped up the quality of its operations.

Financials speak

The extraordinary financial performances of ONGC speak out the efforts put in by the company to make a comeback so as to face the competitive environment post deregulation in India. It has become the only company in India to report a net profit of Rs. 10,529 cr for the financial year 2002-2003 (see the box 'Top Net Profit Reporters' above) on a turnover of Rs. 34,536 cr and announced 300% dividend to its shareholders. It is for the first time that any Indian company had declared a dividend of 300%. It has also the distinction of being the only public sector company in India to have both the EVA and MVA positive.

Not only in terms of net profits, but also in the Indian oil industry it beats its competitors in terms of market capitalization. ONGC enjoys over Rs. 69,900 cr in market capitalization, a figure, which is far ahead of that of Reliance and Indian Oil Corporation, Rs. 45,326 and Rs. 31,766 cr respectively (as on June 30, 2003).

What is the reason behind such a huge profit? Deregulation. Pat comes the reply. Thanks to the dismantling of the administered pricing mechanism from April 1, 2002; ONGC has started realizing the correct prices for its crude oil on par with the international prices for a barrel of oil. Coming to future investments in oil exploration activities, ONGC has set aside about Rs. 15,566 cr, out of which Rs. 10,309 cr will be set for exploration activities in India and the rest abroad.

ONGC Videsh

This company has been playing a crucial role in securing India's oil interests abroad. The company has stakes in about 10 major oilfields outside India. They include: The US, Libya, Russia, Sudan, Syria, Iraq, Iran, Yemen, Myanmar and Vietnam. Out of these some oil reserves are completely owned by ONGC, while some are being owned jointly with other multinational oil companies. It is the constant endeavor of ONGC Videsh to bid for as many international oil blocks as possible in competition with the multinationals, so that the Indian objective of becoming at least 40% oil secured in the coming five to 10 years is fulfilled. The strategy that ONGC Videsh is adopting is to bid successfully and concentrate on those oil blocks, which the multinationals are not at present focusing on so that without much competition they will come under its control. The government too is playing an active role in terms of speeding up the diplomatic efforts to ensure the foreign oilfields in favor of ONGC.

The strategy that ONGC Videsh is adopting is to bid successfully and concentrate on those oil blocks, which the multinationals are not at present focusing

Top 10 Indian Companies in Terms of Net Profits as on March 2003

ONGC	10,529.32
Indian Oil Corporation	6,114.89
Reliance Industries	4,104.00
State Bank of India	3,123.00
Hindustan Lever	1,717.27
GAIL	1,607.01
ITC	1,371.35
BPCL	1,313.00
ICICI Bank	1,206.18
Neyveli Lignite	1,150.84

Source: Business Standard, *June 24, 2003*

Can it withhold?

No doubt ONGC is doing a tremendous job, particularly post deregulation to maintain its No. 1 position in the Indian petrochemicals industry. But over a period of time, big petrochemical multinationals like Exxon-Mobil and British Petroleum will definitely step in to tap the vast potential that Indian markets promise along with competition from domestic companies like Reliance. Once that happens, suddenly the competitive environment would turn fierce and this would be the real testing time for ONGC to prove its mantle. Until then one has/ no option except to praise ONGC for its speedy and successful turnaround.

Ramakrishna Neti

Reference # 1-2003-08-13

ERP INDUSTRY

The road ahead

Recent merger announcements by a few ERP vendors have brought some vital issues regarding the future of ERP industry into the forefront.

Recently, certain events have created ripples in the somewhat dormant $36 bn enterprise software market. First, PeopleSoft had announced that it would acquire JD Edwards another competitor in the enterprise software market. Second, Oracle the No. 2 in the enterprise software market had made a hostile bid for PeopleSoft the No. 3 in the same market, and third Invensys sold its Baan division to an investment group consisting of Cerberus Capital Management and General Atlantic Partners.

The occurring of events raises the question whether the enterprise software market is reaching the maturity stage. Indeed, this market is nearing the maturity stage. The enterprise software sector is highly fragmented, with both big and small players. The small players only provide software products for particular functions while the large players namely, SAP, Oracle and others provide a whole suite of enterprise software products. The revenues of the bigger players like SAP and PeopleSoft and that of the smaller players like I2 have all decreased over the last few years. Giga Information Group, a market research company based in US has also predicted that this sector will grow only 4.8% annually through 2006. With a sluggish growth and companies experiencing a fall in profit margins, players are jockeying to gain market share. Towards that players today are trying to consolidate their positions through mergers and acquisitions. The present situation is due to the boom, which took place in the 1990s.

The growth phase

Though ERP gained popularity (the term first coined by Gartner Group) only in the 1990s, it was existing earlier. Earlier, there was Material Requirement Planning (MRP) and then Manufacturing Resource Planning (MRP II), both of which had some flaws.

In the 1990s, ERP was considered as the biggest enhancement in business software. Managers thought that ERP would change the way their organizations worked as it was designed to integrate every back-office function of their companies into a single integrated system. This would enable the managers to have all types of information, be it sales or inventory or financial at their finger tips because ERP would allow them to control everything from sourcing of raw materials through production and distribution. As a result, large corporations adopted ERP. They installed ERP systems for each function, one for accounting, another for sales, and even for human resources from different suppliers. Upbeat by the benefits of ERP applications, technology managers of many companies persuaded their Chief Information Officers (CIOs) to implement ERP systems in their companies. According to AMR Research, a US-based market research company, between 1997 and 2000, major companies had spent between $250 mn for ERP systems.

The popularity of ERP in the 1990s was also due to the technological innovation that took place during the same period. Before 1990, ERP was mainframe-based. Because mainframe was limited to a few large companies, the popularity of mainframe-based ERP software was less. From 1990, client server architecture became popular and the use of desktop computing gained momentum in companies. Knut Woller, Analyst, Technology Research MEE8TE, HVB Corporates and Markets comments, "ERP software became popular in the 1990s due to client-server innovation (shifting from the mainframe to client-server), which made it a mass market." The evolution of ERP to the mass market made it easy for companies

to optimize the complex internal business processes.

As the demand for implementing ERP software in companies increased, the opportunities for earning profits also increased for the ERP vendors. During the boom time, SAP was indefinitely able to increase its revenues by more than 60% annually. The lure of huge profits attracted large number of big and small players to enter the ERP market. The products of smaller players, who are called best-of-breed software-makers, were good at doing one particular function of an organization, which had to be integrated with the business software of other functions.

The Internet also revolutionized the business software market in the late 1990s. The advent of Internet led to a new term called 'extended enterprise' where companies using Internet technologies could easily collaborate with their customers and suppliers. According to Woller, this gave rise to a large number of specialized 'e' software vendors providing Internet-based software solutions. New growth segments such as eCRM and eSCM emerged. I2 Technologies was the leader in software for managing networks of suppliers.

In the 1990s, ERP was considered as the biggest enhancement in business software

The problems

However, as seen in the past, when a new concept comes into the market, the initial euphoria that the new concept would be a panacea for the existing problems in organizations led to most organizations using ERP. Most of the organizations implemented ERP software without giving a thought on the issues like the compatibility between the existing software and the implemented software and how easily employees and customers could understand the new software. Ram Reddy, President, Tactica Consulting Group, USA also agrees. According to him, "the typical ERP package had the best practices for manufacturing operations, financial management, order processing and so on. Wherever ERP was viewed as a silver bullet to solve and work around bad business practices, it failed to deliver." Companies that have undergone mergers and acquisitions also faced problems, because the unintegrated back-end systems of the newly acquired companies had to be integrated with that of the acquiring company.

The cost of ERP implementation is also very high. According to META Group, a US-based market research firm, ERP implementations cost an average of 1% of corporate revenue for a large company over the life of the project and its implementation takes about 20 months with a time benefit of 27 months. Nestlé USA's $210 mn ERP project which began in 1997 is due for completion in 2003. Implementation also has the hazards of making costly mistakes and dead ends. In 1997, Gillette faced a lot of problems while implementing SAP's R/3 software. Companies had to integrate all the stand-alone software with custom programs, which increased their total costs. AMR found that integration cost bill amounted to around $10 mn for every $1 bn of company revenue.

ERP also affects a company's corporate culture. A decentralized company after ERP implementation would be like a centralized company. Conflicts arise, as people do not like to change and ERP compels them to change in the way they do their jobs. If companies implement ERP software without changing the way people do their jobs, then they would not realize the benefits of ERP. Professor Elliot N Weiss, Isadore Horween Research

"ERP software became popular in the 1990s due to client-server innovation (shifting from the mainframe to client-server), which made it a mass market."

Knut Woller
Analyst
Technology Research MEE8TE
HVB Corporates and Markets

Professor of Business Administration, Associate Dean for MBA Education, University of Virginia says, "ERP rather than changing processes to be more effective, it tended to automate already ineffective processes. The true answer is simplification first and then using IT to control. If done properly, the IT can be significantly simplified."

Reddy opines, "Many corporations saw ERP technology implementation as a way around addressing basic structural issues within their organizations—these implementations failed for the most part. In addition, many corporations realized that they were unwilling or unable to modify their business processes to take advantage of the integrated functionality of ERP."

Another reason was that during the Internet boom period, the traditional ERP vendors such as SAP, Oracle, PeopleSoft and JD Edwards failed to exploit the situation properly. The dotcoms that flourished during the boom period required front-office applications, as they mainly dealt with customers, to integrate with the back-office applications. But the traditional ERP vendors were slow to adapt their client-server architecture with that of Internet computing. As a result, best-of-breed vendors were able to gain

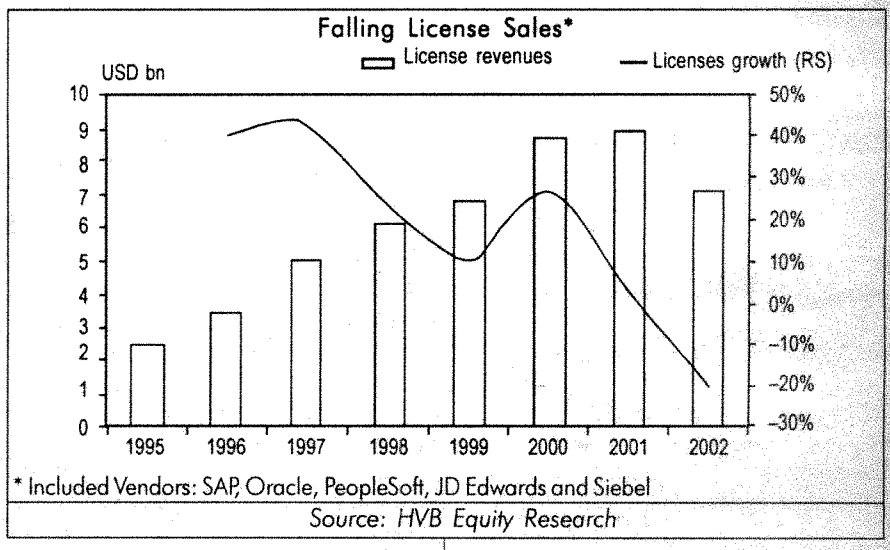
reasonable market share during that period. In 1998, smaller vendors accounted for roughly 63% of the total license market, while the traditional ERP vendors had only 37% market share. Moreover, with the prevailing economic downturn and September 11 attack, companies across the world have given top priority to cost-cutting, as a result, investment in ERP projects have either been stopped or put on hold.

Nearing maturity

All businesses undergo the product life cycle, which is inception, growth, maturity, and decline; it is only the length of each phase that can be changed. Woller opines that once most of the large organizations implement ERP software to streamline business processes, the market would become saturated. On the other hand, organizations also found that ERP could not be a panacea for everything. ERP focused on automating business process but failed to help the managers in key decision-making. As a result, they stopped implementing ERP software in their organizations. Reddy also blames technology vendors partly for this. He opines, "They over-promised and underdelivered." As a result, the business generation for ERP vendors slowed down considerably.

ERP also affects a company's corporate culture. A decentralized company after ERP implementation would be like a centralized company

In a report prepared by Woller on SAP, falling license sales (See Figure), rising ratio of service and maintenance revenues and market share gains for established vendors at the expense of the best-of-breed vendors, suggest that the sector is entering the maturity stage. The licenses as a percentage of total sales have also been declining since 1998 throughout the sector. From the first quarter of 1998, the ratio of license sales to total sales for the vendors like SAP, Oracle, PeopleSoft, JD Edwards and Siebel have fallen from roughly 56% to 28% in the first quarter of 2003. After the dotcom bust, the traditional vendors have again started to regain their lost market share and in 2003 the suite vendors could increase their market share to 39%, which is an indicator that the ERP market is maturing. Woller opines, "Traditional ERP is no innovation in itself (anymore), it has become a commodity for users."



With large organizations saturated, ERP vendors have turned their attention towards the midsize companies. With 45 million such businesses worldwide, the mid-market is attractive. Gartner Group, a market research company has predicted that the small and midsize companies worldwide would spend $420 bn on technology in the year 2003. Besides, this market is not saturated with lower-priced turnkey applications. However, serving this market is not easy. The midsize companies want a solution that is easy to implement, easy to configure and do not take a lot of company's resources. Woller also agrees. He also says, "Vendors need a different sales approach, because a direct sales model applicable to *Fortune* 500 companies if applied to this market will result in margin erosion since the vendors need a higher volume of deals to get the same revenues as with large customers." Reddy views, "Unbundled and affordable ERP modules are what the mid-market companies needed. The biggest challenge is to manage the implementation budgets. A fixed cost approach for a particular functionality will have the most chances of organizational buy-in."

The effect

As the market matures, consolidation would also take place. Reddy validates by saying, "the resources needed to develop, sell and support an ERP package are considerable. The number of customers needed to support a typical ERP vendor is significant to offset these huge development costs. Given the decline in the number of potential ERP customers, it is only natural for the 900 lb gorillas to swallow the smaller competitors." Larry Ellison, CEO of Oracle, also believes that in the near future, the industry would witness a lot of shakeouts, with some of the 'best-of-breed' companies that sell only software that runs customer management systems or supply chain would be acquired by traditional ERP vendors.

Consolidation would give rise to both opportunities and threats to the vendors and customers. From vendors' point of view, consolidation would widen their reach and they would benefit technologically, by getting access to the proprietary technology of the acquired company. It would also open partnerships between ERP suppliers and the smaller more specialized counterparts, which would help in faster product development lower R&D costs. Reddy opines, "Immediate expansion of their customer base, potential reduction in the number of competitors for new business, cherry-picking key technologies from the acquired company are the benefits which ERP vendors accrue. Woller says, "Many established suite vendors had to invest heavily in sales and marketing to keep up in the race of customers' mind share for the new software solutions (there is a decline observed). Besides, bargaining power for the vendors is likely to be better in the consolidated environment."

Fierce competition is expected in the midsize market as large enterprise vendors need to fight with new players such as Microsoft

The supply chain technology developers must ensure that their specific task software remains compatible with the changing ERP market. It might also lead to product consolidation. Reddy opines, "acquired customers may defect to competitors and integrating the acquired competitors technology and organization will be the significant challenge." Problems could arise in company culture, which could create problems for customers.

On the other hand, customers would also be benefitted. Reddy says, "in the long run application integration issues would be minimized. But the threats to customers are immense. Woller views, "It will limit choice and is thus likely to place pricing power of the customers in negotiations. Besides, the question is whether surviving companies will still drive innovations at the same pace in an oligopoly as in the more competitive polypoly." Reddy also agrees on the point that the bargaining power of ERP vendors would increase considerably.

Outlook

In the current economic slowdown, when companies are stressing more on cost-cutting, they are demanding lower overall total cost of ownership for their IT solutions. Companies are looking for reliable vendors with global reach, ability to integrate new product functionalities into existing architecture. As a result, the ERP vendors, who provide the entire suite of enterprise software like SAP, would be the possible winners. Both Woller and Reddy agrees. Woller says, "the trend towards suites will gain pace and that best-of-breed vendors are likely to be squeezed out of the market." According to Reddy, "from the industry point of view, consolidation and more focus on helping clients to successfully implement ERP functionality will become the norm.

From the technology point of view, AMR Research has commented that ERP has reached its architectural limits. The reason being that ERP products like SAP R/3, Oracle 11i and others are designed to provide entire data model, business logic and presentation within the boundaries of an organization, whereas in an era of globalization, extended enterprise ERP products need to adapt to multi-party, multi-tired fulfillment processes. The company has also predicted that real-time Enterprise Performance Management (EPM) would soon be a critical component to integrate with ERP systems. EPM might be the strongest growth area of the successful ERP vendors. On technology aspect, Reddy comments, "there will be more focus on reducing the footprint of integrated packages and delivering functionality as a service as opposed to the technology implementation challenges."

> **"There will be more focus on reducing the footprint of integrated packages and delivering functionality as a service as opposed to the technology implementation challenges."**
>
> **Ram Reddy**
> *President*
> *Tactica Consulting Group, USA*

On the other hand, even though consolidation takes place, fierce competition is expected in the midsize market as large enterprise vendors need to fight with new players such as Microsoft. Microsoft is building its arsenal to attack this segment. Microsoft is creating a base layer of technology, including functions such as order processing and inventory management upon which smaller software makers can build applications. It has also assembled a complete suite of software to automate every aspect of a company's business. In addition, it has spent $2.5 bn in the past two years to acquire Great Plain Software and Navision, both of which make software for small and midsize companies. A few analysts have also predicted that migration of ERP vendors into the mid-market would push the smaller technology firms into niche segments.

Anindya Roy

Reference # 1-2003-08-14

Factors Influencing Industrial Location

It has always been intriguing to know and understand why a few industries are concentrated in a particular location. What are the factors that affect industrial location decisions of firms? How they influence the spatial distribution of development is an important concern for policy makers.

It has been observed that developing countries have relatively lower levels of overall investment and economic activity concentrated in one or a few growth centers. Regions that do not attract dynamic industries are characterized by low productivity, low relative incomes and low standard of living as well. On the whole, this leads to wide economic disparities and lopsided regional development within the nation itself. In such a scenario, understanding the reasons for industrial activity's concentration would facilitate policy makers to create a congenial environment for industrial development, in regions that are not currently attractive for industries.

The decision of the location of the individual firm maybe influenced by many factors such as (i) availability of infrastructure, and the external economies provided by localization and urbanization, i.e., the 'economic geography' (ii) local wages, taxes, subsidies, and incentives, i.e., the 'political economy' and (iii) history, being 'accidental'. This paper focuses on understanding the influence of economic geography on location decisions of firms. Economic geography characteristics include two elements: Market access, represented by the transport network linking a location to market centers; and spatial externalities, represented by the local presence of buyers and suppliers to facilitate inter-industry transfers, the local presence of firms in the same industry to facilitate intra-industry transfers, and the diversity of the local industrial base.

The study is based on information from eight manufacturing industries ranging from food processing to electrical and electronics (including computers) equipment. The paper is organized in three parts, with Part I presenting the analytic framework and specifying the econometric model to examine location decision at the firm level. Part II discusses the results from the econometric analysis. Part III briefly summarizes the contributions and implications of the findings.

Analytical framework

The analytical framework is built upon all the earlier findings in this area. For example, Krugman, Fujita emphasized the importance of supplier and demand linkages and transportation costs. They found that firms prefer to produce each product in a single location given fixed production costs. Firms also prefer to locate their production facilities near large markets to minimize transportation costs. Krugman's research found that manufacturing firms tend to locate in regions with a larger market demand to realize scale economies and minimize transportation cost. Depending on the transport costs, firms' activity is either dispersed or concentrated in a particular area. Transport costs, can be minimized by locating in areas with good access to input and output markets. This proves to be a strong driver of agglomeration towards location where transport costs are low enough that it is relatively cheap to supply markets.

Firms also benefit from being co-located with other firms from the same industry due to the following reasons. First, a large geographic concentration of similar firms can provide scale economies in the production of shared inputs. In addition, firms that utilize similar technologies and face common issues are more likely to collaborate with one another to share information on a variety of issues from problem solving to the development of new production technologies. Second, the benefits from locating beside own industry concentrations can be augmented by the presence of inter-related industries.

Yet another factor that influences location of a firm is the economic diversity of the region. Firms located in larger metro areas are more likely to benefit not only from inter-industry technology spillovers but also from easier access to producer services such as legal services or banking.

Market access: Access to the marketplace is an important consideration in the firm's location decision. Empirical research suggests that simple inverse distance weighting describes a more

© ICFAI Press. All Rights Reserved. Summarized version of the research paper "The Economic Geography of Industry Location in India" by Somik V Lal and Jun Koo, Development Research Group, World Bank, Washington, DC, USA and Sanjoy Chakravorty, Department of Geography and Urban Studies, Temple University, Philadelphia, PA, USA.

rapid decline of interaction with increasing distance than is often observed in the real world (Weibull, 1976).

Own industry concentration: Co-location of the firms from the same industry leads to productivity enhancement of all the firms. The benefits of such concentration include sharing of sector-specific inputs, skilled labor, and knowledge, intra-industry linkages, and opportunities for efficient subcontracting. In the case of specialized inputs and production technologies, firms are more likely to cooperate by launching joint projects for new product and process development. In addition, this concentration of firms increases the possibility of collective action to lobby regulators or bid prices of intermediate products. There is downside to such concentration in terms of enhanced competition between firms for labor and land causing wages and rents to raise, as well as higher transport costs due to congestion. Therefore, the net benefits of own industry concentration may be marginal for sectors with low skilled labor and standardized technologies.

Inter-industry linkages: While intra-industry concentration definitely has an impact on the profitability and location decisions of the firm, intra-industry linkages also have a decisive impact. In the case of industries that are highly dependent on the supply of high quality intermediate goods, firms are more likely to locate in a region where there is a strong presence of suppliers. The presence of suppliers makes the buyer industries more efficient and reinforces the localization process.

Economic diversity: Chinitz (1961) and Jacobs (1969) proposed that important knowledge transfers primarily occur across industries and the diversity of local industry mix is important for externality benefits. They argue that cities are breeding grounds for new ideas and innovations due to the diversity of knowledge sources concentrated and shared in cities. The diversity of cities facilitates innovative experiments with an array of processes, and therefore new products are more likely to be developed in diversified cities. Therefore, industries tend to cluster in more diverse and larger metro areas. Economic diversity has an influence on both production and consumption. Recent empirical studies by Bostic *et al.* (1997) and Garcia-Mila and McGuire (1993) show that diversity in economic activity has considerable bearing on the levels of regional economic growth.

Findings

The econometric analysis of the above variables yielded the following results. For a better understanding, the firms are categorized based on their size into small (less than 50 employees), medium (employees between 50 and 99) and large (more than 100). All the four parameters are analyzed for their industry-wide influence as well as for the different sized firms.

Research suggests that the net cost reducing impact of market access is not significant in most industry sectors at the industry level. In the case of small firms, research indicates benefits from improved market access particularly in the case of chemicals and metals. In the case of textiles, it is observed that higher market access actually increases the costs. In the case of medium and large firms, market access estimates are not statistically significant.

For own industry concentration, industry-wide estimates suggest that there are no net benefits of being located beside own industry concentrations. Estimates actually suggest that costs increase if firms are located in regions with high concentrations of the same industry. Even when the results are disaggregated by firm size, own industry concentration systematically provides either no net benefits and, in some instances, actually increases costs at the firm level.

In the case of intra-industry linkages, the findings show that for most industry sectors, proximity to buyers and suppliers potentially reduces costs at the firm level. However, it differs from industry to industry. For example, in the case of large firms in food and beverage and electrical/electronics, being located in regions with relatively higher buyer-supplier linkages increased the costs.

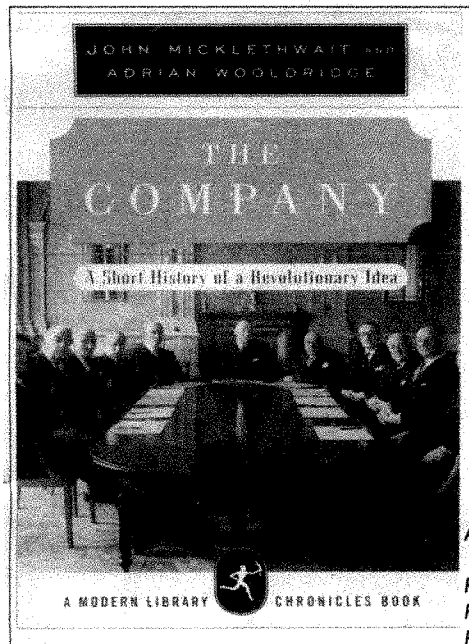
Results for economic diversity indicate that there are considerable cost-reducing benefits from being located in a diverse region. Industry-wide estimates suggest that this impact is felt across all the industries studied. The results are stronger in the case of smaller firms. They indicate that economic diversity has a statistically significant impact on five of the eight sectors. In the case of small firms, there are considerable benefits of being located in a diverse economic region. Being located in a diverse region, small firms reap benefits from better opportunities for subcontracting, access to a general pool of skilled labor, and access to business services, such as banking, advertising, and legal services. In addition to these pecuniary externalities, there are potential technological externalities from knowledge transfer across industries. In the case of medium and large firms however, similar benefits are not found. Most probably because larger firms are more vertically integrated and with higher fixed costs, are not likely to benefit from these externalities.

Thus the research indicates that economic diversity is an important driver in the economic development of a nation. This understanding could prove very helpful for policy makers embarking on a policy of widespread economic development of the country.

DG Prasuna

The Company

A Short History of a Revolutionary Idea



Authors: ***John Micklethwait and Adrian Wooldridge***
Pages: *227*
Price: *$19.95*
Publisher: *Random House Inc.*

From the beginning of economic life, businesspeople have looked for ways to share the risks and rewards of their activities. Over the years, companies have proved to be enormously powerful not just because they have improved productivity, but because they possess smost of the legal rights of a human being, without the disadvantages of biology. Most of the governments are no longer of the people, by the people and for the people. They are of corporations, by corporations and for the corporations.

A company is the most important organization in the world. In fact, its history is an extraordinary tale. There are two ways to define a company. The first is merely as an organization engaged in business; the second is more specific—the limited-liability joint stock company which is a distinct legal entity, endowed by government with certain collective rights and responsibilities. In 16th and 17th centuries, European monarchs created charted companies to pursue their dreams of imperial expansion. One of these, the East India Company, wound up ruling India with a private army of 26,000 native troops (twice the size of the British Army). Another, the Virginia Company, helped to introduce the revolutionary concept of democracy to the American colonies.

Throughout the 20th century, the company moved with the state that spawned it. European and Asian governments tried to run companies of their own and failed miserably. Meanwhile, the ways that companies have subtly influenced the human lives multiplied. In a Company, three themes stand out, first, the company's past is often more dramatic than its present. The second point is to some extent a correlation of the first. In general, companies have become more ethical; more honest; more humane and more socially responsible. The early history of companies was often one of imperialism and speculation, of appalling rip-offs and even massacres.

A Company is an attempt to chart the rise of remarkable institution and its future. Yet, the company is much less powerful than it seems. Although the influence of companies as a species has never been more widespread, the clout of individual big companies has arguably declined. Big companies are giving way to small ones, so much so, an old question is now more pressing. This should not imply that the company is beginning a slow, inevitable decline. Despite the seductive charm of frictionless capitalism, most people seem to like being associated with companies. But the basic questions being asked by modern investors, managers, and workers are: What does the company

do? Why do I work here? Will it make money? are worth remembering as we head back into the past.

Merchants and Monopolists (3000 BC – 1500 AD)

Before the modern company came of age in the mid-19th century, it had an incredibly protracted and often highly irresponsible youth. The merchants and marauders, imperialists and speculators, who dominated business life for so many centuries, might not have formed full-fledged companies, but they nevertheless created powerful organizations that changed commercial life. When Rome crumbled, the focus of commercial life moved eastward to India, and particularly to China and the Islamic world. The Chinese, meanwhile, opened up a huge technological lead over the West. Within a decade of William the Conqueror dispatching Harold at the Battle of Hastings (1066), Chinese factories were producing 125,000 tonnes of iron a year—a figure Europe would not match for 700 years. The zenith of Chinese economic imperialism came in the early 15th century, when the Ming emperor Yung Lo, who ascended the throne in 1403, built a fleet of huge treasure ships, which he dispatched around Asia. The Chinese made rapid progress in technology; they also pioneered the concept of paper money. Marco Polo who traveled in China during 1275-1292 traded junks. In 1497, Vasco da Gama made it round the Cape of Good Hope to East Africa.

Imperialists and Speculators, 1500-1750

The 16th and 17th centuries saw the emergence of 'chartered companies'. These companies were complex entities. In 1700, the British East India Company employed more than 350 employees in its head office, more than many modern multinationals. These chartered companies lasted long; the British East India company lasted for 274 years. The Hudson's Bay Company founded in 1670 is the world's oldest surviving multinational. The chartered companies were created by the governments and merchants to exploit the riches of the new world which were opened by Columbus (1451-1506), Magellan (1480-1521), and Vasco da Gama (1469-1524). All these companies were armed with royal charters, which gave them exclusive rights to trade with the new world.

These chartered companies also drew on two other ideas from the middle ages. The first was the idea of shares that could be sold in the open market. The idea in offering shares in enterprises dates back at least to the 13th century. The first chartered joint stock company was the Muscovy Company, which was finally given its charter in 1555. Two decades earlier, a group of London merchants had dispatched a fleet in a predictably disastrous attempt to find a northern passage to the East Indies. They created the extraordinary company of the period, The English East India Company.

The Honorable Company

The London's grandest society of merchants possessed an army, ruled a vast tract of the world. It all began on September 24, 1599, when a group of 80 dynamic merchants met at the Founders Hall in the City of London under the chairmanship of the Lord Mayor, Sir Stephen Soane, agreed to petition Elizabeth I to set up a company to trade with the East Indies. It faced stiff competition from the Dutch and Portuguese. All this required sophisticated administration. Most of the companies' predecessors have been little more than regulatory bodies, which created a two-tier structure. The General Court, which included all the shareholders with voting rights; many of these were bigwigs from court and parliament. The day-to-day management was entrusted to the court of directors, 24 men all elected by the General Court. The governors and his deputy, assisted by a growing number of accountants, clerks and cashiers, worked through seven committees specializing in accounting, buying, correspondence, shipping, finance warehousing, and private trade. The court of directors also supervised the overseas network of resident 'factors' that managed the local trading posts or factories.

The East India Company was the strongest of all the chartered companies. It possessed an army, ruled a vast tract of the world, and created one of the world's greatest civil services. Though the company faced stiff opposition from the Dutch and the Portuguese, it was not enough to stop it from making rapid progress. The early voyages of the company proved quite profitable. For example, the 10th voyage, in 1611, earned a return of 148% on its shareholders' capital of £46,092.

By the late 17th century, the East India Company was a well-organized monopoly. It provided some £20,000 in customs duties to the crown. But the company being a state monopoly was mired in politics. It was accused of draining away Britain's precious silver. Some also questioned whether a single monopoly should account for half of Britain's trade? Should businessmen govern overseas territories? Should a company have a private army?

The company soon became involved in Indian politics. The East

About the Authors

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The authors are co-authors of *A Future Perfect: The Challenge and Promise of Globalization* and *The Witch Doctors: Making Sense of the Management Gurus*.

India Company gained political foothold in India after capturing Calcutta in 1756 defeating the Nawab of Bengal at the Battle of Plassey. The subsequent victory over the Mughals at Buxur in 1764 gave them control over Bengal. However, the increasing political power of East India Company raised many issues. It was argued that it should be nationalized. In the 19th century it was brought under tighter control and in 1813, the government abolished its monopoly of trade. In 1833, it was deprived of its rights to trade altogether. The company's army was passed to the crown, and with the expiry of the charter on June 1, 1874, the extraordinary company met its end.

A Prolonged and Painful Birth, 1750-1862

The joint stock companies fared badly for the next century. These companies were also unpopular with early industrialists. In Britain, the marginal position of joint stock companies could easily blame on the South Sea Company's abuses. Most of the companies had monopolies, but governments were notoriously fickle, rewriting charters on a whim. The importance of tradable equities increased, particularly once railways started issuing preference shares, which provided guaranteed dividends. The modern company began to take shape from 1820s onwards after a combination of legal and economic changes. The two most dynamic and controversial parts of the British economy—the slave trade and the growing industrial sector—preferred partnerships and at times joint ventures to joint stock companies. While in Britain, the joint stock companies were no longer preferred, in the newly independent America, these companies were used to build some of the very important infrastructure—universities, banks, canals, municipalities, and roads.

Though partnerships were given preference both in Britain and in America, they were far from perfect. One problem was that the death of a key partner or even an heir often killed the firm. In newly independent America, by contrast, companies had been responsible for the country's very existence. In the first half of the 19th century, the stage began with participation in the affairs of the companies. There were three reasons for this. The first was the railroad, the second was legal and the third was political. When the states realized that they were losing potential business and legislatures, they slowly began to loosen their control over companies. Two significant changes took place in the first half of the 19th century. In 1830, the Massachusetts state legislature declared that companies need not be engaged in public works to be awarded the privilege of limited liability. In 1837, Connecticut allowed firms to become incorporated without special legislative enactment.

In the 1840s, many changes were made in Britain's company laws. The 1844 Act allowed companies to be incorporated by the simple act of registration without getting a special charter. But it did not include the crucial ingredient of automatic limited liability. The Joint Stock Companies Act of 1856 removed the qualifications of the Limited Liability Act. The 1856 Act allowed businesses to obtain limited liability with "a freedom amounting almost to license." The Act in its slightly modified form became the comprehensive 1862 Companies Act. Between the Acts of 1856 and 1862, almost 25,000 limited liability companies were incorporated. Subsequently many changes were made in the company laws of other countries, which resulted the boom in company creation: 203 companies were set up in 1871, 478 in 1872, and 162 in 1873.

All these developments drove the point that company was a political creation. It was a product of a political battle, not just a result of technological innovation. The debate in the mid-19th century Britain revolved around: "Is the company essentially a private association, subject to the laws of the state but with no greater obligation than making money, or a public one which is supposed to act in the public interest?" Though some governments felt that the companies were to be left alone, others demanded more. Definitely, companies had political and social impact on the society. Further, the industrial economy's need for establishing economies of scale and scope would drive the big company to the forefront of capitalism and society—but it would do so most notably in the US.

The Rise of Big Business in America, 1862-1913

The US was at the forefront of business activity during the late 19th and early 20th century. A new system of transport and communication made possible the growth of business. Railroads were great enablers for modern business. The railroads brought a far-flung country together and made possible the movement of goods around the country quickly and predictably.

Snapshot

In *The Company*, three themes stand out, first, the company's past is often more dramatic than its present. The second point is to some extent a correlation of the first. In general, companies have become more ethical; more honest; more humane and more socially responsible. The early history of companies was often one of imperialism and speculation, of appalling rip-offs and even massacres. Today the number of private sector companies that a country boasts—the US—had 5½ million corporations in 2001. This leads to the third point. The company has been one of the West's great competitive advantages. The West's success owes much to technological prowess and liberal values. However, in the mid-19th century, the effect of Western governments delegating key decisions about which ideas to back to independent firms was revolutionary.

The first American companies that took advantage of railways were in distribution and retailing. The 1870s and 1880s saw the rise of modern mass retailers which included chain stores, department stores, and mail order companies. Manufacturing was slow to catch on and it was only after the Civil War that the number of manufacturing companies increased by 80%. The credit for reengineering production goes to Andrew Carnegie (1835-1919). Carnegie introduced the 'line production' system arranging machines and workers into a sequence that allowed jobs to be broken down into their component parts. Carnegie exploited the advantages of economies of scale. He argued, "The larger the scale of the operation, the cheaper the product."

The line production system was perfected by Henry Ford (1863-1947). Ford's engineers borrowed ideas of the first management guru, Frederick Taylor whose *Principles of Scientific Management* was published in 1911. The success of Ford was mainly because of integrating mass production and mass distribution under the roof of a single organization. Integrated companies which did not exist in the late 19th century dominated America's most vital industries by the turn of the century. In the early 20th century, the Americans demanded some regulations to restrict the companies from behaving the way they liked. The politicians were under pressure to break up the empires of the 'malefactors of great wealth'. In 1906, Teddy's Roosevelt's administration launched a successful antitrust suit against Standard Oil and in 1911, the Supreme Court ruled that it be broken up which created the forerunners of Exxon, Mobil, and Chevron.

The Rise of Big Business in Britain, Germany, and Japan, 1850-1950

Though the United States was at the forefront of economic activity in the late 19th and early 20th century, Britain, Germany and Japan were soon to catch up. Though we have seen that Britain was the pioneer in setting up companies free from state control, in the late 19th century it failed to produce big industrial firms. The reason for Britain's failure to capitalize on its first mover advantage was that British entrepreneurs used the personal approach to business while the Americans embraced professionalism. Also, for American industrialists, companies were an end in themselves but for British industrialists they were a means to a higher end: A civilized existence.

Though Germany was united only in 1871, over the next 40 years it had built companies which replaced Britain as Europe's leading industrial power. However, Japan's version of organized capital had many similarities to Germany. Japan also embraced the concept of company during the late 19th century. However, post World War I saw the success of big American business. It also saw an important innovation—introduction of multidivisional firm. The multidivisional firm was an important innovation because it professionalized the big company and set its dominant structure. It was also important because it became the template for 'managerialism'. The first two decades of the 20th century also saw the gradual separation of ownership and control. Another important development during the 20th century was the spread of business schools.

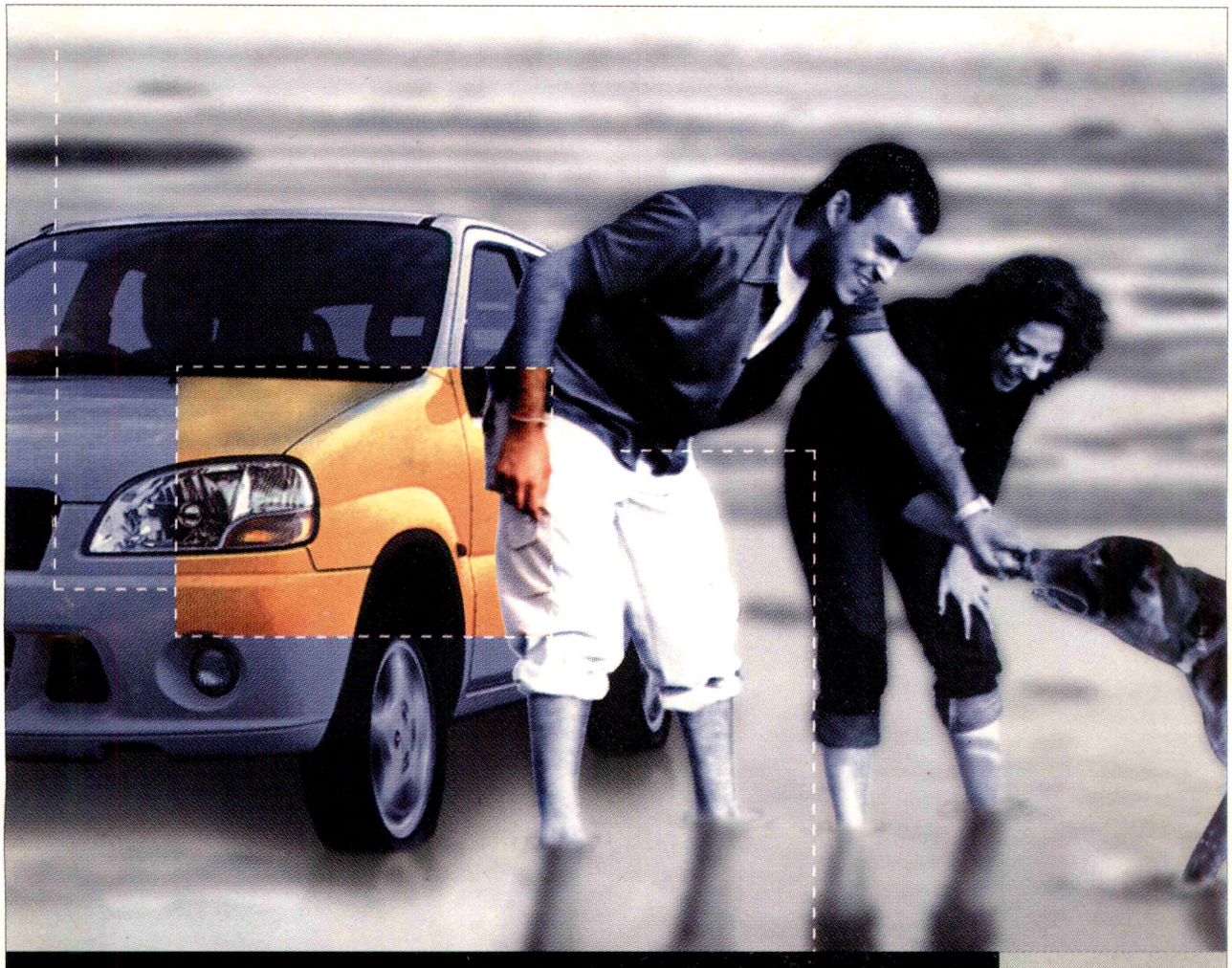
The Corporate Paradox, 1975-2002

During the late 1990s, the triumph of private sector capitalism was conspicuous. However, the fragility of individual firms had profound effects on the company's relationship with the rest of the society. There were many doubts and frustrations bubbling to the surface after the Enron scandal in 2002. Post Enron scandal changed the corporate world. The Sarbanes-Oxley Act was signed to discipline corporate America. Many corporate bosses who were once adored by the general public were now facing criminal charges. The Enron scandal was followed by similar scandals such as Xerox and AOL Time Warner. American corporation which was the trendsetter for the company for most of the previous century was dogged in controversy in the 21st century. This raised the old debate whether companies were supposed to merely make money legally or be active agents for the common good of society. Many of the frustrations about what companies owed to the society focused on one type of company, the multinational. By 1914, a number of American companies had factories abroad. In 1938, the total stock of foreign direct investment was estimated to be $26.4 bn of which 40% was British and 28% was American. By 1960, the global stock of accumulated foreign direct investment had swollen to $66 bn and the United States held 49% of this compared with Britain's 16%.

Future of the Company

What would happen to companies in the future? There are three possible views. The first view is that a handful of companies will have more economic power but without any sense of responsibility and accountability. The second view holds that companies will retreat to the periphery of the economy. The third forecast is that discrete companies will be replaced by the 'network'. However, the future of the company would depend on what the society can do for the company rather than what the company can do for the society. Though governments have deregulated markets, still they are regulating companies with more enthusiasm than ever before. The question is will society find a way to exploit an organization, which is collectively indispensable but individually unpredictable? As the authors state: "To keep on doing business, the modern company still needs a franchise from society, and the terms of that franchise still matter enormously."

N Janardhan Rao



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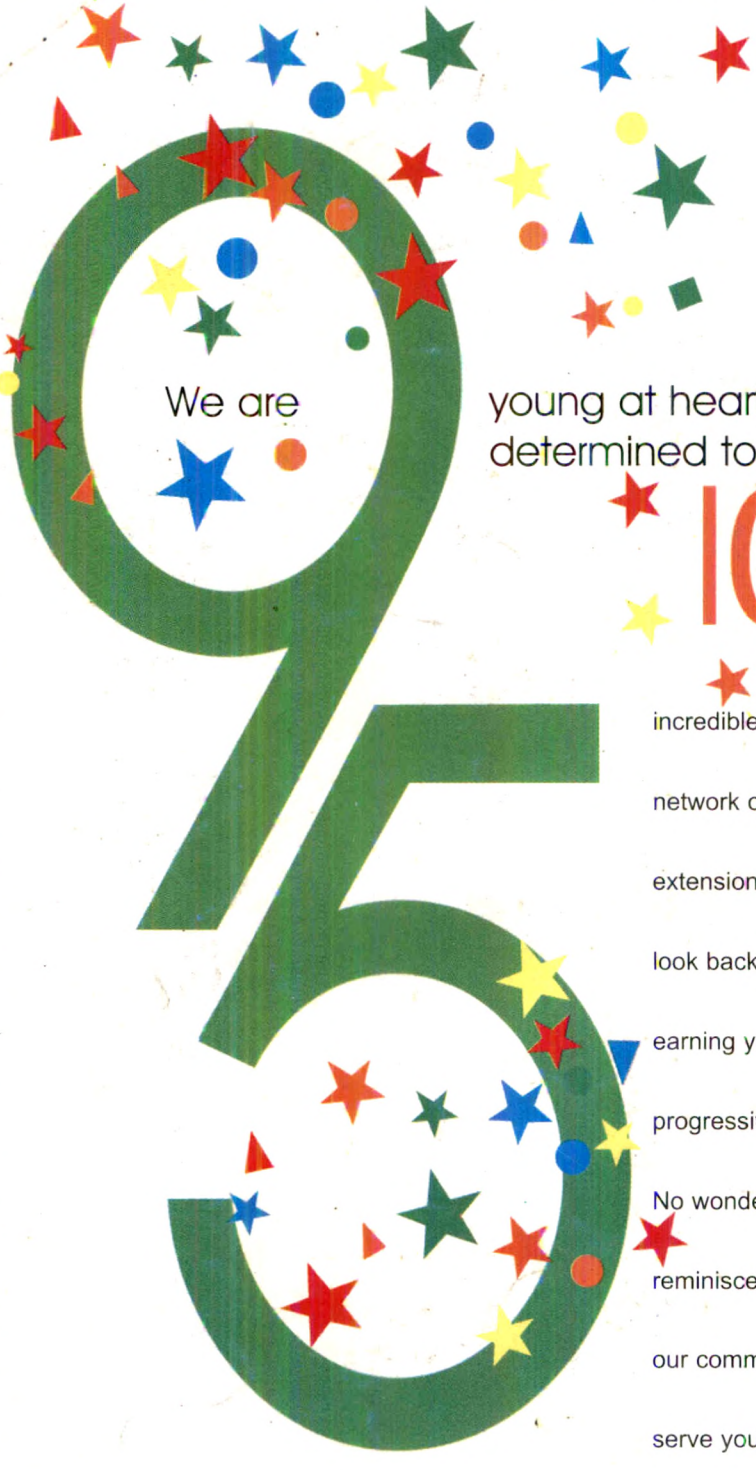

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September 2003

The New Age Finance Magazine

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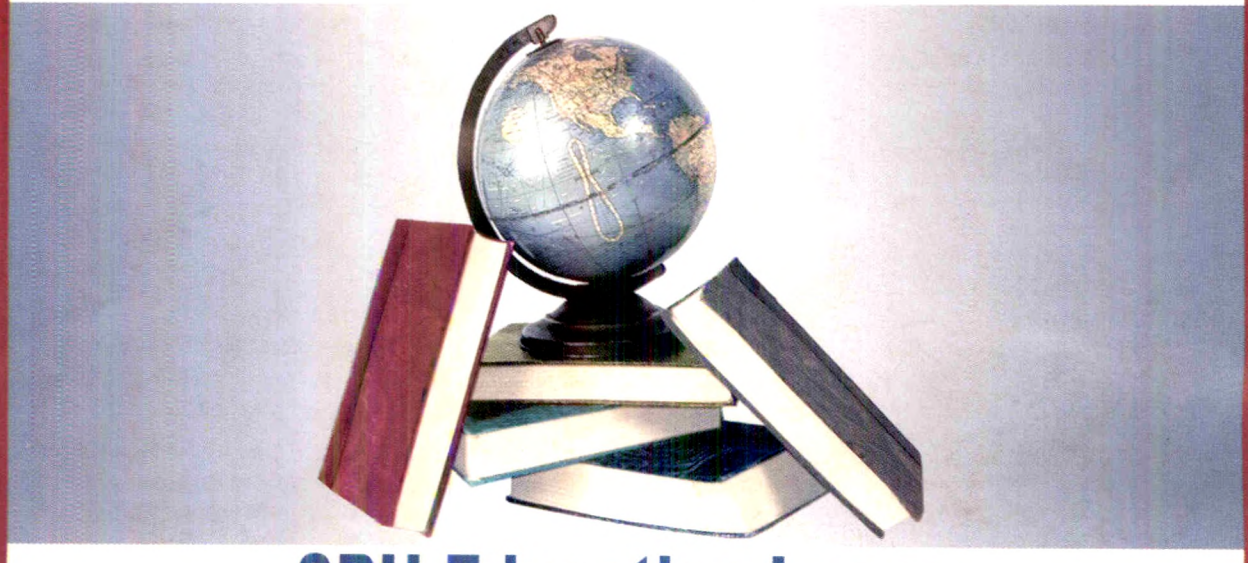

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ISSN 0972-5053

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Printed and published by E N Murthy on behalf of The Institute of Chartered Financial Analysts of India, The ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh. Printed at M/s ICIT Software Center Pvt. Ltd. (Press Division), 3-112, Fatehnagar, Sanathnagar P.O., Hyderabad - 500018, Andhra Pradesh and published from The Institute of Chartered Financial Analysts of India, The ICFAI University, Plot # 52, Nagarjuna Hills, Panjagutta, Hyderabad-500 082, Andhra Pradesh.
Editor: E N Murthy

The Job Migration Wave

We may call it the second wave of globalization of services, technology services in particular. Increasingly, corporates from the developed nations like USA are shifting their jobs to low-cost locations like India. While it all started with the low-end activities like call centers, it is now fast spreading to high-skill areas also. It's no longer confined to IT; virtually every services business is keen on shifting the 'transportable' jobs in their business to low-cost overseas locations.

Over a period of time, all the necessary preconditions have emerged facilitating the migration that has just begun. The increased connectivity among the different nations across the globe, emergence of global village, MNCs' steadfast focus on cost competitiveness and readiness to go an extra mile to create wealth for their shareholders, availability of highly skilled services workforce in the developing nations, and increased transportability of services jobs are the factors responsible for the job shift.

This reminds us of what happened in manufacturing. Just as the making of semiconductors, electronics, toys and a host of other goods had shifted to emerging economies, a similar trend appears to be emerging in the services arena too.

The migration of jobs in manufacturing has never resulted in a popular backlash in the developed countries earlier, for it was largely confined to low-skilled, blue-collar strata. But the services shift that is occurring now is already witnessing the shift of well paid, white-collar jobs. This has the recipe for backlash, which the companies have to encounter.

Accentuating this trend is the difficult business environment that has emerged as a result of the burst of the tech bubble and the slowdown that ensued. Pressure to keep the costs low is very high to remain competitive and more importantly to remain profitable. Companies are keen on shifting any job that is transportable, provided it results in cost reduction. The risk associated with the strategy is an area that remains unexplored. It becomes inevitable in a free market that the jobs tend to shift to those places that provide similar quality service for a far lesser price.

The trend is a welcome change for the developing nations where plenty of highly skilled workforce is available. This increases the employment levels and results in economic prosperity. In India, the IT sector has grown from less than a billion dollars to about $8 bn. This is expected to reach $50 bn with resulting rub off on the GDP.

For Indian IT companies the challenge is twofold. The big MNCs will reap the cost advantages by relocating jobs and become more competitive. This apart, Indian IT companies have to target product development and brand-building to move up the value chain.

Ch Rajeshwer

Letters to the Editor

The Best Finance Magazine

I go through many magazines in finance but I feel *Analyst* is the best among the buds. A beginner too can well understand the current world of finance and business through *Analyst*. It has an in-depth study of everything on the block and my knowledge has truly expanded by reading this magazine.

Saurabh Agarwala
sauvy@rediffmail.com

Investing in 'Gold'

The article on gold was very interesting and enlightening. The interrelation between gold and dollar and how gold is used as a safe investment during times of uncertainty made a very good read. In fact during the War on Iraq, we have practically seen the value of gold go up in a very short span of time. It would be interesting if Indians too look at gold as an investment avenue.

Lalitha Goyal
Lucknow

China – Far Ahead

The cover story on China and India's trade relations was very timely. Personally I feel China is far ahead on many aspects as compared to India. Not only has it started off the reforms process earlier, but also its implementation has been much better than India's. Thus it would be quite some time before India catches up with China and that too only with concentrated efforts.

Pratap Sinha
Ahmedabad

Verbatim

To my mind, the situation is possible only after you have achieved certain proven surpluses. At that stage an IPO is likely to evoke positive response from the market. To offer an IPO only on the basis of assets and not visible liquid surpluses may not really be the best way out.

– Sunil Arora, CMD, Indian Airlines, on the possibility of the airline striking the markets with an IPO.

The biggest challenge for IT companies trying to offer high value-added services is grooming a code writer to become a consultant.

– Sangita Singh, Chief Marketing Officer, Wipro, in an interview with Business Line.

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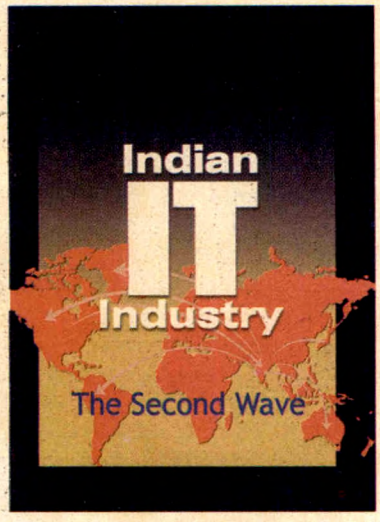

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Stock Options Under Fire

The latest news from Microsoft centered on its announcement to discontinue the practice of granting employee stock options and use restricted stock in its place. Although this seems to have taken many people by surprise, it shouldn't have, as all publicly traded companies wrestle with the realities of the recently enacted Sarbanes-Oxley Act, the uncertainty caused by the debate on expensing options, and the continuing public outcry about compensation excesses.

Basically, Microsoft indicated that upon shareholder and SEC approval, it would discontinue granting any stock options to employees, and would only issue restricted stock with vesting requirements in the future. To entice employees currently holding stock options, many of which are 'underwater', to give up the approximately 1.7 billion options, it has arranged to allow JP Morgan to purchase them at a nominal cash amount. It is assumed that the company will continue to honor the exercise of stock options that are vested and 'in the money'. They may even accelerate those unvested, but 'in the money' options, that is strictly conjecture.

Obviously, this move is driven to a large degree by tax and accounting considerations, or at least anticipated changes affecting stock options. Since options have become such a significant portion of the total compensation package which has an impact on employees at most levels, and amounting to as much as 50% or more of the senior executives' package, it is critical that every company considers the impact of this move to restricted stocks relative to their own situation.

The following table provides a comparison of stock option and restricted stock grants since 1998 as contained in the ECS Industry Report on Top Management Compensation Surveys. The big question is how will the anticipated changes from granting of Stock Options to Restricted Stock change this picture in 2004 and beyond.

(in %)

Year	Non-Qualified Stock Options	Incentive Stock Options	Restricted Stock
1998	56.7	36.4	26.0
2000	57.7	39.9	26.4
2002	63.1	38.7	25.2

The change in compensation strategy announced by Microsoft has re-ignited the controversy of which pay components, and in particular, which stock-based plans should be used. This will have an immediate impact on all companies as they continue to compete for top talent, and motivate employees to strive for the profitable growth that is most common of all corporate goals.

Daniel P Moynihan, Principal
Compensation Resources, Inc.

Discount Retailing

Price is a critical determinant of business success. Take it or leave it, more often than not, a consumer is price-sensitive who hunts for cheap bargains. He needs value for his money and thus has contributed to the rise of the concept of discount retailing that made its appearance in the early 1900s when America was torn between war and financial depression. The Kresge Stores, later known as Kmart, soothed the war-distressed and unemployed Americans by their varied merchandise that came at discounted prices. Over the years, many discount stores took root in America as well as in Europe and other continents. Prominent among them were Wal-Mart in US and Aldi in Europe. These retailers operated on slim margins and the volumes more than made up the losses due to low margins.

The star of discount retailing, Wal-Mart that came into being in 1962, revolutionized the industry with its tough negotiations, a strong brand name and good customer service. It showed to its rivals like the pioneer, Kmart, which recently emerged from bankruptcy, that just selling at lower than others or at slim margins isn't enough to succeed in this market. Rather, a robust brand, which reflects the low-price promise, coupled with tough negotiations with the manufacturers dictates survival and success. That's why Wal-Mart, Kohl's and the others have laboriously built a brand name for themselves reflecting their commitment of offering low-price merchandise. And because of their strong brand association with low price, customers come to them and manufacturers bow in to their negotiations. This only shows how the model is difficult to duplicate. Like in the Airlines industry, where only a few have been successful with the 'No-Frills' approach, very few have been able to succeed with the 'discount' approach in retailing. No wonder that in airlines industry, many claim to be no-frills airlines, but none is Southwest. Likewise in the retailing arena, many are discount retailers but none is Wal-Mart.

This business is a complex game of relationships between various entities of the retailing value chain, where giants like Wal-Mart and Target have shown many a retailer, a working, extendable model. At the same time, small, local retailers in India and other emerging countries have slowly but surely created a niche of their own by their uniqueness and innovation. The Yansha outlets of China, the hypermarkets and massive discount supermarkets of Thailand and the super bazaars of India like Apna Bazar, Subhiksha and the like, have profitably spread the concept in their areas. And as discount retailing spreads far and near, its abundance might give way to new, cheaper concepts like wholesale clubs, or go back to the full customer service models like the kirana stores.

C S V Ratna

The 'Other' Side

The corporate results of India Inc. during the second quarter that ended in June were quite impressive to watch. There were a few firsts with ONGC becoming the first Indian company to cross the 10,000 crore mark in net profits for 2002-03, and Reliance becoming the first private company in India to post a quarterly net profit of over Rs. 1,000 cr. In addition to these general trends, a number of companies have staged a turnaround last year thus improving the overall picture. There are many factors that contributed to the better results. The low interest rates prompted many companies to restructure their debt and cost-cutting measures of many companies have finally paid off. Then some sectors such as banking benefitted from their renewed focus on certain market segments.

'Other' income

The 'other income' in the books has become prominent in the results this time. Of course, this was in addition to the other factors. Many companies have booked substantial higher 'other income' in this quarter. According to *Business Standard,* the other income of a sample of 1,350 companies in the manufacturing sector alone increased to Rs. 3,395.76 cr for the quarter ended June 2003, a 21.47% jump over the same quarter a year ago. There is a school of thought which believes that Indian corporates have a huge surplus of cash as a result of lack of investment opportunities and better working capital management. And this cash is used in investment creating a huge scope for intelligent treasury operations, which could boost the bottom line in the form of other income. This is true to a large extent. The other income component also includes dividends from subsidiaries. Some analysts believe that this has also added up the bottom line figures that corporate India has put up. The significant part played by other income has risen considerably in absolute terms for the present quarter. As a percentage of the total income it has come down from around 21 to 18%, which indicates that the income of companies on the whole has risen faster than other income.

On the whole, corporate India has been able to perform better than expected, whether it was due to improved internal controls or congenial external markets or better other income. Most probably it is a combination of all the factors.

D G Prasuna

BSE: In Tune with Global Standards

The strength of the companies in the popular BSE sensex would no longer be based on market capitalization. Instead, the free float would be the new measure of strength. The weights of the companies would be now determined by the free float. Free float is the number of shares which are actively traded and are available to the public. Free float does not include the shares which are blocked like the promoters' stake and the government shares.

Determining the weights of the company based on free float is the globally accepted best practice. Most of the leading index providers globally have switched to free float. In fact, free float is not new to India. The BSE TECK index is constructed on the free float basis. Free float is the actual measure of liquidity of the stock from the retail investor's point of view. Even if the market capitalization of the stock is high there might be a large portion of the stock which is blocked and not traded. So, rewarding such company with higher weights would only create a demand for the stock especially by the passive fund managers who should have that stock in their portfolio. This creates a rise in stock prices.

So, in the adjustment for the free float some stocks would be the gainers and some the losers. Companies with high free float like Infosys and ICICI Bank would see their weight increase, while companies with higher promoter holdings whether in the form of government holding or in the form of foreign parent company holding like HLL and SBI would be the major losers.

Coming to the question as to whether this would force the divestment process in the PSUs is not really sure. But in any divestment process the price and market timing is more important criteria.

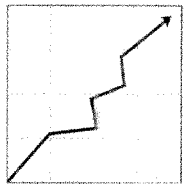
However, the change in the weights would not be that significant to see a sudden surge or fall of the stock prices. This is because the amount of money in the index funds in India is very small and significant and the announcement of free float was made six weeks before the actual date. This has given enough time to the fund managers to adjust their portfolio accordingly.

This is a welcome move as the global investors especially the FIIs are generally used to benchmark their portfolio and investment to the free float indices globally. What more! There is also a talk on introduction of some new stocks like Maruti into the sensex once the free float methodology stabilizes. This would only further generate interest in the sensex.

D Satish

NATIONAL

Forex reserves up by $297 mn



India's forex reserves have gone up by $297 mn to touch $84.997 bn for the week ended August 8, 2003, following a revaluation of the RBI's basket of currencies.

Reserves had taken a dip of $204 mn in the previous week. The revaluation has been demonstrated by a corresponding increase of $297 mn in RBI's foreign currency assets, taking the total assets to $81.364 bn.

According to forex dealers, dollar inflows during this period were regular but not extraordinary. Due to Infosys' ADR proceeds coming in, there were lot of inflows last week. But at this point, there was substantial RBI intervention in the market, in terms of sucking out surplus dollars and this in turn was getting reflected in a substantial jump in the reserves each week.

India's tax policies rank third in the world

India ranks third on an international tax misery index that attempts to measure the relative attractiveness of a country's tax and social security policies to multinationals looking to set up base.

The index, created by Ernst & Young, ranks 50 countries and shows India's score at a low 79.3 in 2003 (a lower score indicates a higher rank). Ernst & Young for *Forbes* created the index, in its fifth year, on global taxation practices. It is intended to show where each country stands on the amount of burden it imposes on entrepreneurs in terms of individual and corporate tax rates as well as social security contributions.

Hong Kong takes the top spot with 43, while France brings up the rear at 179.4 even though it has reduced its misery score substantially since 2001, by lowering tax rates. China ranks 45th and the United States finds itself in the eighth position.

The study says China does not score well because it has to go a long way towards providing incentives to business people beyond that of a mammoth emerging market.

The West European countries have generally performed worse on the misery index because of a combination of high marginal rates of direct tax and heavy mandatory contributions to social security.

India, which imposes no social security contribution on employers and which is reducing its tax rates, therefore, scores much better.

Though the article acknowledges that tax is not the sole factor in choosing a business location, it says when equally attractive options are available, the tie-breaker is generally tax.

Where talent is the value proposition

World-class processes lead to higher employee satisfaction, ultimately furthering customer satisfaction, making it simpler to retain talent.

Akin to ISO 9001, ISO 14000 and Six Sigma standards, simply put, PCMM is an internationally accepted practice to grade employers. PCMM is basically a conceptual model based on the state-of-the-art workforce practices to help organizations tune up their act. This helps to develop the workforce required to execute business strategies, characterize maturity of workforce practices, set priorities for improving workforce capabilities, integrate improvements in processes and finally become an employer of choice.

Wipro InfoTech climbed up to the 'employer of choice' category, by international standards, after it was placed at the fifth level (version 2) on the People Capability Maturity Model (PCMM) late last year.

This business unit of software major Wipro has been graded at the highest level in the latest PCMM version. Wipro had also received the highest grade (fifth) in the earlier version.

Shabbir Merchant, General Manager, Human Resources, Wipro InfoTech, says that these grades are of paramount importance as talent is the key and critical differentiator in our industry.

Developed by Software Engineering Institute under the auspices of the Carnegie Melon University, the PCMM framework at version 2 has 22 process areas and 495 practices across the five levels. Most levels in this methodology encourage building sustainable models while streamlining people processes around competencies.

This exercise was undertaken across its 22 locations in India, giving it also the distinction of getting this grade across the entire enterprise with a workforce of nearly 2000.

Wipro believed that in the knowledge economy, talent does not support the value proposition rather talent is the value proposition.

Hyundai profits boosted by strong exports

Hyundai Motor, South Korea's largest carmaker saw an 86% surge in second-quarter profit, higher than expected, boosted by exports of luxury sedans and sports utility vehicles.

Net income rose to Won570 bn ($480 mn) for the period, up from Won307 bn last year. The company, whose exports to Europe have benefitted from the strong euro, is hoping that the export market will drive further growth in the second half, as it suffers weak demand at home. Exports account for about 60% of Hyundai's annual earnings.

First half exports to Europe rose 34.5% from a year ago to 141,000 vehicles, while shipments to North America rose 18% to 266,000 vehicles.

However, a recent strike at Hyundai has cast a shadow over profit forecasts for the company, which is 10% owned by DaimlerChrysler. The strike is thought to have cost the company as much as $1.2 bn in lost production and profits are predicted to fall after Hyundai agreed to increase employees' salaries following the strike. Shares of Hyundai rose 1.4% at Won33,050.

Life and pensions groups told to cut costs

UK life and pensions companies have been warned that they must halve their rapidly growing administration costs to be able to offer low-cost 'stakeholder' investment products being developed by the Treasury.

The latest annual returns by companies to the Financial Services Authority, the City regulator, show that it costs UK product providers more than £30 a year, on average, to administer each individual policy on their books in 2002, up from £28 in 2001 and £25.50 in 2000.

A software and outsourcing provider Marlborough Stirling conducted the analysis.

Brian Please, Head of Life and Pensions Propositions at Marlborough Stirling, said one reason for the surge in costs was unexpected burdens such as the review of millions of mortgage endowment policies. But the industry was also being hit by falling sales volumes. Having geared up for growth, companies are struggling to scale back their cost base in terms of staff numbers and buildings. They are caught in a fixed-costs trap, with sales flat or even falling.

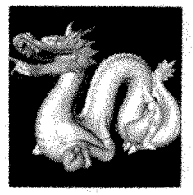
The government last month announced details of 'stakeholder' products, which will go on sale in 2005 following recommendations in Treasury. They called for cheap and simple new products that could be sold without the need for financial advice.

Charges on existing government-sponsored 'stakeholder' pensions are already capped at 1% to keep them competitive, but the industry argues that this offers little incentive to offer new products, and has lobbied hard for additional charges to cover advice.

Ministers argue that financial services companies could profit from the new products if they were more efficient.

China rejects Basel II rules

China has formally rejected the so-called Basel II rules governing the amount of capital that banks are obliged to operate with, and decided to introduce its own requirements on capital adequacy.



Like India, China has decided that the new accord drawn up by the Bank for International Settlements in Basel does not take into account the particular circumstances of banks in developing countries.

Liu Mingkang, Head of the China Banking Regulatory Commission (CBRC), believed that Basel II would be more risk sensitive than Basel I and would increase the overall capital for banking system.

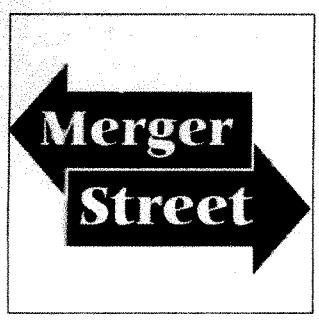
China's own rules will retain an 8% minimum capital adequacy ratio requirement but will also include requirements for supervision and information disclosure, two elements in the new accord.

China said it would stick with the old Basel accord for a number of years beyond 2006, when G-10 countries will start implementing the new guidelines. Chinese officials said that the policy would maintain pressure on its banks to continue reforms, without placing unreasonable, and unachievable demands on its institutions.

Nevertheless, the move represents yet another assault on the proposals, after years of negotiations to establish new standards aimed at making the world's banking system more efficient.

Some bankers privately estimate the new rules could lead to their capital charge—the minimum amount of capital they are obliged to hold—rising by up to 60%, making the profitability of some activities significantly less attractive.

Indu Prasad



Oil companies merge

The merger of Russian oil companies Yukos and Sibneft received formal approval from the government. The merger if it goes through would create the world's fourth-largest oil producer. According to the terms of the agreement, Yukos will pay $3 bn in cash for an initial 20% stake in Sibneft, then acquire the rest by exchanging Sibneft shares for shares in the newly formed company. The total value of the deal is not yet clear and could range anywhere between $12 bn and $15 bn (€13 bn, £9.3 bn). The new company is to be named Yukos-Sibneft Oil Co. and will have to refrain from using its dominant position in regional retail markets to force out small players.

The anti-monopoly ministry of Russia approved the merger with some conditions, which according to analysts' opinion are not very stringent and do not include any forced sell-offs. The regulatory approval brings relief putting to rest the fears of derailment of the merger due to the numerous criminal investigations and tax probes launched against Yukos and its shareholders this summer. Yukos has been in a tense battle with Russia's prosecutor-general since early July when Platon Lebedev, one of its top shareholders, was arrested and charged with fraud in a 1994 fertilizer plant privatization deal.

Swiss medical device companies merge

In a bid to create a global osteosynthesis, medical device company Synthes-Stratec, Inc. (Stratec) and Mathys Medical Ltd. (Mathys), have entered into an agreement to combine both the companies. Both the companies are of Swedish origin. Synthes-Stratec is purchasing all Mathys' shares for CHF 1 bn in cash and CHF 500 mn in Synthes-Stratec equity, issuing 510,725 ordinary shares. The cash portion of the transaction will be financed with cash on hand plus bank borrowings. After the transaction goes through the combined company will have net debt (debt less cash) of approximately CHF 610 mn. UBS Investment Bank advised Mathys while CSFB Corp. acted as the advisor for Stratec. The merger deal is subject to the approval of regulators as well as shareholders and is expected to be cleared by the end of the year.

Synthes-Stratec is a leading international medical device company, specializing in the development, manufacturing and marketing of osteosynthesis instruments and implants. Synthes-Stratec develops the highest quality osteosynthesis products for surgeons in the specialties of orthopedic trauma, spine, craniomaxillofacial, and veterinary surgery. The company employs over 4,100 people, with headquarters in Paoli, Pennsylvania and in Oberdorf, Switzerland.

Mathys is a family-owned company comprising of osteosynthesis and prosthetics businesses, with over 1,800 employees. In 2002 the osteosynthesis business contributed CHF 383 mn in revenues to Mathys. The company designs, manufactures, and markets instruments and implants for trauma, spine, craniomaxillofacial and orthopedic surgeons. Mathys' prosthetics business will not be a part of the combination. Prior to the transaction, the Mathys family will transfer all prosthetic operations into an independent company under the name Mathys Ltd.

First Niagara buys Troy Financial

First Niagara Financial Group (Niagara), Inc., a holding company for First Niagara Bank, has entered into a definitive agreement to acquire Troy Financial Corp. (Troy), which is a holding company for The Troy Savings Bank and The Troy Commercial Bank. The total consideration for the acquisition was decided at $333.5 mn. According to the terms of the agreement, Niagara will be paying $35.50 per share for Troy. 57% of the consideration is to be paid in cash with the rest being paid in stock. The deal is expected to be closed by the year-end. Keefe Bruyette & Woods were the financial advisors for Troy Financial Corp., while Ryan Beck & Co. advised First Niagara Financial Group, Inc.

The acquisition would expand the presence of First Niagara in New York and also increase its asset base by about $1.2 bn. Company sources estimate that the acquisition would be accretive to its 2004 EPS by about 14.0%, based on forecasted pre-tax cost savings of about $10.7 mn.

Siemens Life Support Systems acquired

Siemens Life Support Systems (SLSS) is being acquired by Getinge, the acquisitive Swedish medical technology group for a total consideration of €150 mn ($169 mn). The acquisition will make Getinge a leader

SIEMENS

in ventilators alongside Dräger of Germany. According to company sources, the acquisition of SLSS, which is expected to generate sales of €205 mn this year, would make a strong contribution to earnings, adding €10 mn—€12 mn to pre-tax profits in 2004. Getinge estimates that the cost of integration would be around €25 mn and would result in a goodwill value of €175 mn.

Getinge has built up its medical technology business in ventilators, surgery, sterilization and wound care through a string of acquisitions over the past decade. Recently, it has received antitrust approval for the acquisition of Jostra, a German manufacturer of open-heart surgery equipment.

Zimmer bid recommended

Centerpulse, the Swiss orthopaedics company recommended the offer of Zimmer, a US company to its shareholders. Zimmer had made an offer to acquire Centerpulse at SFr4.32 bn ($3.15 bn). Zimmer for its part has welcomed the recommendation. The acquisition would boost Zimmer's European operations and make it the world's biggest reconstructive surgery company, with a leading position in artificial hips and knees.

Centerpulse had been on block for quite some time now. Zimmer had walked away from the Centerpulse auction last year, but returned with a surprise hostile approach worth SFr364.2 a share after Smith & Nephew (S&N), UK's largest medical group, offered SFr294.30 a share in an agreed takeover. As a reaction to Zimmer's offer S&N had hinted that it would come back with a higher offer. But recently it has pulled out of the race stating that a slowdown in the European orthopaedics market made the combination less attractive. There is industry wide consolidation in the fast-growing orthopaedics market, which is dominated by US group's Stryker, Johnson & Johnson and soon Zimmer.

Government intervention

DaimlerChrysler (DC), the auto major created by the merger of Germany's Daimler Benz and US' Chrysler Corporation, is busy trying to shed its non-core assets. As a part of these efforts the company has proposed to sell MTU, its aero-engine business. DC has decided to auction MTU, which is valued at about €1.8 bn ($2.03 bn). According to sources bids have come in from a consortium of JF Lehman, Morgan Stanley and Kohlberg Kravis & Roberts in the US, as well as Doughty Hanson of the UK, Blackstone Partners of the US, and Carlyle Group of the US. The unit was put up for sale in March and the preferred bidder is to be selected by the end of August.

However, the German Government is rather concerned about this sale. MTU has a chunk of defense-related activities and it is in this connection that the government is concerned. Since most of the bidders are foreign investors, from the point of view of Germany, there is an increasing concern about their taking over defense-related activities. Some of the Nato members have already introduced legislation limiting foreign investment in defense companies to less than 25% to stop unwanted transfers of sensitive technology. Germany too might contemplate such legislation. As of now, the German Government is keenly studying the deal. Such questions about foreign investors' participation have been raised earlier in Britain and Italy.

PaperlinX to acquire Buhrmann

PaperlinX

PaperlinX, Australia's biggest paper maker, which had announced in June that it is acquiring Buhrmann's paper merchanting arm is very positive about the earnings in the first year, despite the Buhrmann's recent weak performance and general market conditions. The price of the merger is yet to be finalized. Initially PaperlinX had agreed to pay €746 mn ($840 mn), which according to many analysts is too high.

The due diligence of the planned acquisition is yet to be completed according to sources. Company sources maintain that the delay is understandable given the business size and the number of operating units of Buhrmann. The acquisition will make PaperlinX the world's third-largest paper-selling business and accelerate its international expansion. After the merger the combined company would be generating more than half its earnings outside Australia.

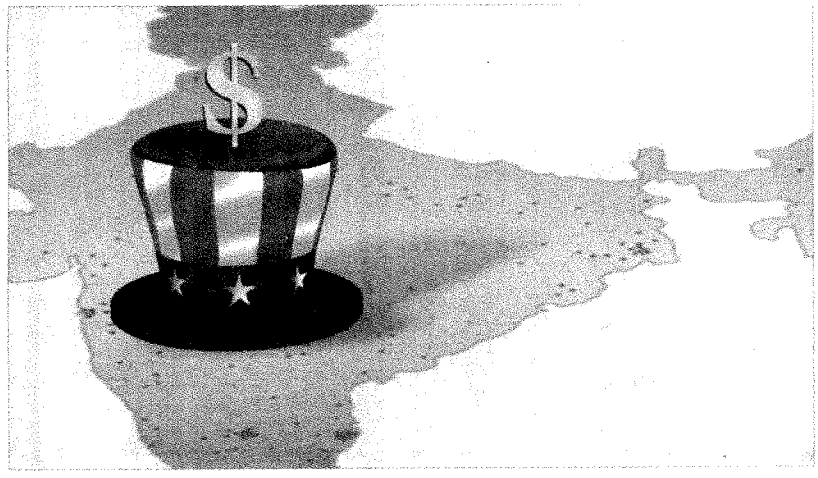
PaperlinX reported a 7% increase in full-year net profits from A$123 mn to A$132 mn (US$81 mn to US$87 mn) but expressed concern that growth was dragged down by cheaper imported copy paper, low international demand and the appreciating Australian dollar. Buhrmann posted a steep fall in second-quarter net earnings and company sources mentioned that they saw no sign of a pick-up in European markets.

D G Prasuna

INDIA INC.

The new found love

Given the sluggish state of many economies, FIIs are attracted by India's strong fundamentals. The renewed interests of Warren Buffett in Indian stocks is expected to change the dynamics of Indian markets.

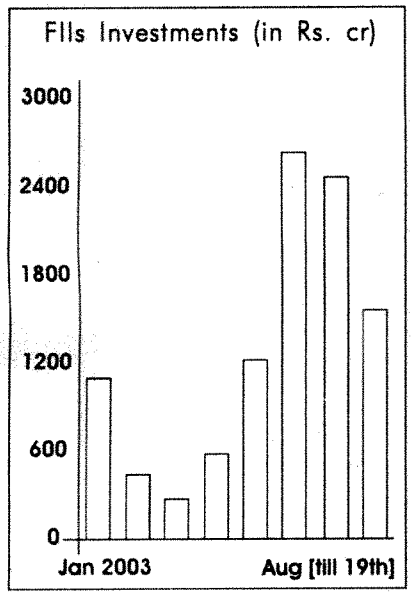


India opened up to Foreign Institutional Investors (FIIs) about 10 years ago and that is now bringing in more than $17 bn to the country. Since January 2003, foreign investments are $2.37 bn in the Indian market. In fact, the number of FIIs operating in India has crossed over 500 from 480 six months ago. Going by these facts, India is suddenly developing as the most attractive emerging market in Asia. Many factors are attributing to the sudden spurt of FIIs activity in India. On the domestic front, the Indian economy seems to be on the roll. There were a range of positive factors led by hopes of a strong economic revival after the timely arrival of the monsoon rains, reduced tensions between India and Pakistan, beyond this, the Indian corporates reporting impressive sales and profit growth. Compared to its counterparts, India's return on equity is rising by the day. Globally, plummeting stock market and falling interest rates have also boosted India's confidence. Experts say that there are also other reasons for this relative bluishness on India. It is one of the fastest-growing economies in Asia, promising a growth of over 5%. An expected surge in consumer demand from India's huge and powerful rural sector will drive stock market performance as well. Overall, the optimism runs high on India. FIIs are not investing in a few Indian companies as recommended by their analysts, but they are attracted by India's strong fundamentals. Ved Prakash Chaturvedi, CEO, Tata TD Warehouse Mutual Fund, says that though the undervaluation in the market has been corrected to some extent, growth in the economy, a stable currency and lack of alternative avenues for investment are driving the investment frenzy. He further adds, "From a short-term perspective , the market may be oveheated but from a medium-term perspective there are still a lot of investment opportunities."

The story does not end here; on the external front it has never been so good. The galloping foreign exchange reserves (in excess of $82 bn) have made the International Monetary Fund (IMF) select India as a member of its Financial Transaction Plan (FTP), under which the country will contribute to the fund's liquidity that is used to help countries overcome balance of payment problems. India thus, after decades of being a borrower country for the IMF, now becomes a member of its lender league. "Selection of India as a member of the FTP, for the first time by the IMF, sends strong signals regarding the country's strength and the resilience of its external sector to the international community," says the Reserve Bank of India.

Going by these developments, it's not a surprise that BSE Sensex has crossed the psychologically crucial 4,000-mark. This is expected to provide a feel good factor and thus will boost consumption and investment. Unlike in the past, the Sensex has been much more broad based and has been driven largely by commodity and consumer stocks.

The recent successful disinvestment process by Maruti Udyog has urged the government to complete the strategic sale of Hindustan Petroleum by November 2003. This prompted the legendary US-based stock investor Warren Buffett to test the Indian market. Currently Buffett is buying oil stocks globally including those in India. The reported interest of Berkshire Hathaway, Inc. of Warren Buffett in the Indian Oil stocks is expected to change the dynamics. According to sources, Buffett is going to grab a big share, somewhere around 5 to 7% stake



in large oil and gas companies. He says, "valuations of Indian oil stocks are being rewritten considering their intrinsic potentials. There is a sector re-rating happening here." Analysts say this is a booster for the positive sentiments in Indian markets. According to global fund managers, there are primarily two reasons behind India emerging as a favorite. First, over the past four weeks, India has been among the best performing markets. The MSCI India index has gained 12% in dollar terms (Korea was up 10%), while Morgan Stanley's MSCI Emerging Markets Free Index Asia and MSCI Global Emerging Market indices gained 8% and 5% respectively during the same period.

Chris Cheetam, Global Chief Investment Officer, HSBC Asset Management, London, is bullish on the Indian markets. He says, "Indian companies are now increasingly focusing on profits and the macroeconomic environment has the potential to attract increased FII inflows. It is this confidence that has led to a huge bout of buying by FIIs. They have invested more than $2 bn into Indian stocks and bonds so far in 2003, capping a sharp surge in net inflows in the past few months that have driven the sensex and the rupee to multi-year highs." This is the fourth time in almost 10 years since India opened up to foreign investors that net FII inflows have crossed the $2 bn mark. Many FIIs have even started predicting that considering the current macroeconomic situation and strong liquidity, the current year may witness record inflows (already India reported its highest FII inflow so far in 1996 at $3 bn). There is a mix of short-term and long-term funds investing in India. "Many are new to the Indian market," says U R Bhat, Head of Broking at JP Morgan Securities adding, "This year may just be one of the best years yet for FII inflows."

However, experts say despite the fact that about 6,000-odd companies are listed on the Indian bourses, Indian markets are small in size compared to many others in the region. For instance, on May 30, 2003 Hong Kong, the largest market in Asia, had a market cap of $444 bn. Taiwan had a market cap of $188 bn, Korea $179 bn and China $115 bn. India had a market cap of a relatively modest $99 bn. Moreover, India's market capitalization to gross domestic product ratio of about 20% is still among the lowest in the region. "That itself poses a limit to FII investments," says Bhat. He further says, "The fiscal deficit is a major concern for global investors. "Unless the government makes serious efforts at fiscal consolidation, foreign investors may not be confident of India." If one forgets the lingo, very soon, we will come to know whether the living legend of American investments—Warren Buffett would agree to these sentiments.

N Janardhan Rao

FUND OF FUNDS

Double diversification

The recent Sebi nod for Fund of Funds would allow investors to diversify their funds across different schemes through one mutual fund scheme.

If you are thinking of investing your money in different mutual fund schemes but do not have the time to track their performance then Fund of Funds is just the right scheme meant for you. As compared to normal mutual funds, which invest in securities like stocks and debt instruments, a Fund of Funds invests in various mutual fund schemes. In effect it is a mutual fund, which invests in other mutual funds.

What is it all about?

Obviously, investing in a Fund of Funds has its advantages. It offers double diversification as the initial diversification is achieved by the mutual funds, which invest in various securities, and the second level of diversification comes when the Fund of Funds diversify across various such mutual funds. It is also a simple means of investing as one can invest in Fund of Funds instead of many different funds, which cut down on the paperwork. For an investor who does not have enough funds to invest in all the schemes he desires, Fund of Funds provides an alternative as with a minimal sum, it gives an opportunity to invest in a variety of mutual fund schemes. For example, if an investor wants to invest in many mutual fund schemes he would have to invest in at least one unit of each of those mutual funds which might involve quite some money but by investing in a single unit of a Fund of Funds he gets an opportunity to invest in a number of mutual fund schemes. On the flip side there are worries that the fees would be higher as the Fund of Funds buys different mutual fund schemes themselves. Fund of Funds would charge fees at a level that would entice investors to create the same portfolio buying different mutual funds themselves. Most Fund of Funds also carry a high expense ratio that drag down the returns one time.

Fund of Funds invests in various mutual fund schemes. It is a mutual fund, which invests in other mutual funds

Global experience

Fund of Funds is quite popular internationally. These funds have different investment patterns and strategies as disclosed in the offer document. This would help investors select a Fund of Funds scheme that caters to their particular needs and objectives. There are also sector Fund of Funds which focus on industry or geographic sector investment themes, such as telecom, media, technology etc. It also provides the investor an opportunity to invest in private equity funds.

Indian debut

In India a Fund of Funds scheme could not be launched till recently as Sebi restricted mutual funds from investing in other mutual funds up to 5% of the Net Asset Value (NAV). On the other hand, the Indian mutual fund industry also was not conducive to Fund of Funds as each of the mutual funds had small number of schemes. For Fund of Funds it would be ideal to have a good number of schemes.

Sebi has now cleared the proposal for starting Fund of Funds with a few restrictions like a Fund of Funds cannot invest in another Fund of Funds and mutual funds cannot invest in another Fund of Funds. On the crucial aspect of fees Sebi has stipulated that the total expenses of Fund of Fund schemes including management fees should not exceed 0.75% of the daily or weekly average net assets depending on whether the NAV of the scheme is calculated on the daily or weekly basis. This might be a difficult thing for the fund managers as expense ratio of the Indian mutual funds range from 0.5% to 2.5 based on whether the fund is tilted towards debt or equity.

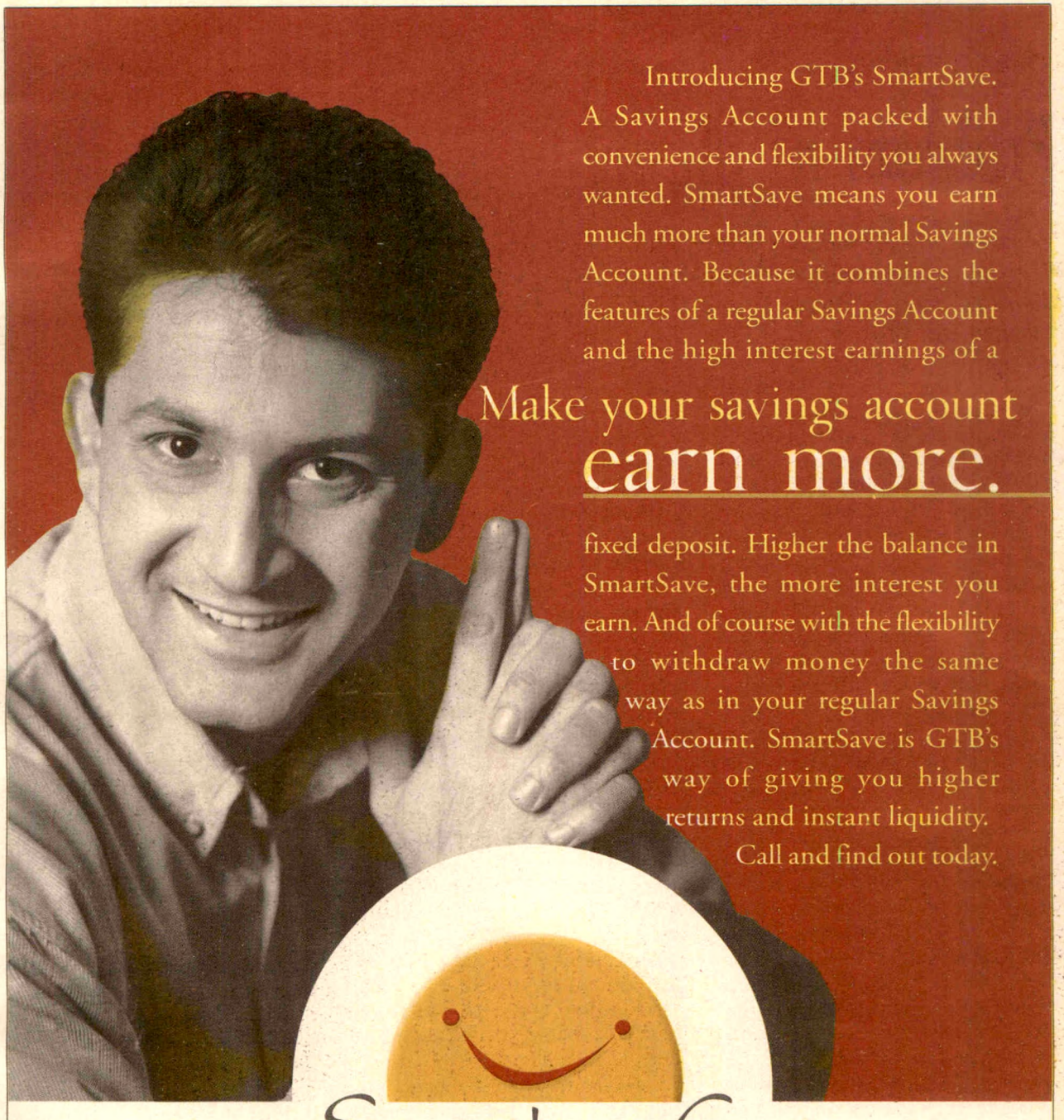
A Fund of Funds should invest its entire net assets, barring the funds required for meeting the liquidity requirements for purchases, in other mutual fund schemes as disclosed in the offer document.

Can the Fund of Funds carve a niche for itself? Is the Fund of Funds a right pill to spruce the mutual fund sector? Perhaps time would answer these questions. But for now, all the major mutual funds are making moves to start Fund of Funds.

Franklin Templeton Mutual Fund is one of the first to launch a Fund of Funds scheme called the India Life Cycle Fund. The scheme would invest in a combination of Franklin Templeton India's equity and income funds and carry plans with varying debt and equity proportions.

D Satish

Reference # 1-2003-09-02



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FOREX RESERVES

Problem of plenty

The rise in forex reserves is certainly a welcome change. However, the moot question is whether India can continue to afford the rising reserves? says C Rama Gopal, Professor, VNS Institute of Management, Bhopal.

No doubt, high level of reserves not only proclaim our financial strength but also our ability to meet financial obligations. It is also a measure of success of our financial reforms, and provides evidence of our continuing commitment. Forex reserves have been enjoying the aura, all along, similar to careful monitoring of the temperature of a convalescing patient, only with a difference: Rise is certainly welcome rather than a fall. Yet, the relevant question to be addressed is whether we can continue to afford the sky rising reserves and if so at what cost to carry them?

Composition of reserves

Foreign exchange reserves are in the form of Special Drawing Rights (SDRs), gold and foreign currency. It is the effort of every Central Bank to build up a high level of foreign exchange reserves. Reserve Bank of India (RBI), which is the monetary authority and custodian of foreign exchange reserves, has been planning for building up the reserves. Due to its incessant efforts, the reserves have swelled and, now, stand at a pedestal figure—$84 bn as on July 30, 2003. Our Finance Minister has already gone on record that the reserves shall touch $100 bn, not in 'distant' future. RBI has been endeavoring to improve the level of strength, after the balance of payment crisis that engulfed our economy a decade ago. The foreign exchange crisis of 1990—an unforgettable event—was so severe that the reserves of $5,834 mn were just adequate for three week's imports.

A section of analysts believe that the strength of the Indian economy is not the bait enticing the inflows. Rather, it is the disappointing state of the world economy that is diverting funds to India. Recent World Bank report has indicated that the surge of inflow has been due to September 11, 2001 attack on US and instability due to war in Iraq. However, Finance Minister has strongly contradicted the reasons for the flow of capital.

Where did they come from?

Basically, a country's balance of payment ledger consists of transactions under two main heads: Current Account and Capital Account. In the Current Account, there are two main types of transactions recorded, namely: Merchandise and Non-Merchandise type. The latter is properly called invisibles and typically includes services, private transfers, investment income etc. The first two are the most important and these transactions under these heads have really boosted the balance of payments over the past few years. Software exports fall within the service group. It appears a little strange that such an important sector has not been given a pride of place as a separate item in the service group. Remittances and repatriation of savings by working Indians abroad, sent home for consumption—non-returnable in nature—fall in the category of transfer receipts, under Current Account. Remittances sent by Non-Resident Indians (NRIs) for deposit in NRE (rupee) account—returnable in future—fall under Capital Account.

During the financial year 2002-2003, NRI deposits of various kinds accounted 12% of the total accretion. India has received $10 bn remittances from its countrymen in the year 2001, the highest for any country. These remittances account 2% of the GDP. While the importance of remittances has always been recognized, it is only after the liberalization of the foreign exchange regime and the fundamental changes brought about in the exchange rate policy, invisibles have increased.

The country's forex kitty has swelled by $21 bn in 2002-2003. From 2001 onwards inflows have risen much faster than before. This is no mean achievement. It has always been advocated that an increase in exports requires rupee to be cheap. However, exports have been growing, despite rupee appreciating persistently.

India has set a modest 12% annual export target for the year ending March 2004, despite 18% growth in the previous year, because of fears of a global economic slowdown and the rise of the Indian rupee against US dollar. Exports between April and June have jumped 11.06% to $13.14 bn in the previous year. This is the second year we have seen a surplus on the current account front.

Another route through which inflows are rising is the surge in External Commercial Borrowings (ECB) by corporate India. Already $1.4 bn has been raised in the first half of the calendar year 2003 using the ECB route. ECB has turned positive in the last quarter (January-March 2003) after a gap of 12 quarters. This compares very well with the $1.7 bn raised in the whole of last year. This is primarily due to widening interest rate differentials between India and US/ Europe.

FII investment in debt, earlier capped at $1 bn, has been raised to

$2 bn in the last week of July 2003. FII have been investing in treasury bills of 91 to 364 days which is giving them 4.8-5% return while the government securities of five-year maturity are offering somewhat between 5.2-5.3%. Even after hedging the rupee-dollar fluctuation risk, FII can manage to send home over 2% by investing in totally risk-free sovereign securities. These are the risk-free returns, which the FII are enjoying.

The RBI attributes some of the rise in reserves to the revaluation of reserves. This happens because a part of the Central Bank's reserves are held in other international currencies. As these appreciate against the dollar, the total reserves measured in dollar terms go up.

How much is enough?

Right now, reserves provide an import cover for 16-18 months. It is a far cry from the situation that prevailed in 1990, when the reserves were abysmally low. Many economists are of the opinion that the optimal level of reserves should last for a minimum period of three months. The High Level Committee on Balance of Payments chaired by Dr. C Rangarajan recommended that the level of reserves should be able to accommodate imports of three months.

The Foreign Currency Assets to Currency (FCA-C) ratio touched 107% in July 2002. It means that the net forex assets with RBI are more than the total cash in the system and with the public by 7%.

To his credit, RBI governor Bimal Jalan has tried to raise the issue of adequacy of reserves, unfortunately without meeting the issue squarely. In the overview of the economy that preceded the monetary policy statement for April 2000, Jalan says, "It is now widely agreed that in judging the adequacy of reserves in emerging economies, it's not enough to relate the size of the reserves to the quantum of merchandise imports, or the size of the current account deficit." He goes on to suggest that for judging how much is enough, one has to take into account the composition of capital flows, particularly short-term external liabilities. Fair enough. But not far enough.

Sources of Accretion to Foreign Exchange Reserves

($ bn)

	Apr.-Dec. 2002	Jan.-Mar. 2003	Apr.-Mar. 2002-03
Current account balance	3.00	0.70	3.70
Capital account (net)	9.70	3.60	13.30
a. Foreign investment	3.10	1.50	4.60
b. Banking capital	6.80	1.40	8.20
NRI deposits	2.40	0.40	0.80
c. Short-term credit	0.40	0.60	1.00
d. External commercial borrowings	-2.00	0.30	-1.70
e. Other items in capital account	1.40	-0.20	1.20
Valuation change	3.20	0.60	3.80
Total	15.90	4.90	20.80

The RBI justifies the high level of reserves as a prerequisite to gain international investor confidence, which in turn will attract foreign investment. This is true. Only rich can easily borrow, though they may not need, but not the poor though they need, badly. Moreover, economic matters are not short-term concerns but must be viewed with medium or long-term perspective. What level of reserves should be considered adequate to look into the issue of carrying cost of reserves? Cost implications are never considered till the level is achieved, in the national interests.

What does this indicate?

It is the first time in 40 years that the otherwise traditionally descending rupee is staging a forward march. The rupee has been strengthening against all major currencies, save the euro. On a year-over-year basis (July 17, 2003), it has appreciated more than 5% against the dollar, 7.6% against the Japanese yen, and 3.7% against the solid British pound. By contrast, it has lost around 5% against the euro.

What does this all portend? The direction of the rupee is clear. Prediction is that the rupee will continue to gain against the dollar. It will continue to stride forward and in the process instill more confidence in overseas investors.

Arbitrage

Arbitrage includes exploiting the difference in interest rates in currency between different markets or even countries. If interest rates for dollar are higher in India than USA, a higher return will be obtained by switching funds from USA to India. Some NRIs may be capitalizing opportunities—essentially diverting their own money from the country of low interest rates to deploying in India to skim off the difference between the interest rates.

The arbitrage is not necessarily done by NRIs alone. The profit opportunity is being exploited by corporates through short-term external borrowings that are invested in India. FIIs are investing in short-term and sovereign debt paper too, to take advantage. Even banks are bringing in short-term capital from overseas. Reasons for arbitrage are twofold—interest differential that exists between markets and the expectation that the rupee would appreciate further or, at least, remain stable.

The problem with arbitrage inflows is that they are, by their very nature, freckle. Any squeeze in the arbitrage window would lead to a flight of capital, with reversal of flows.

NRE deposits

There has been a flush of NRE deposits to take interest advantage that prevails in India. Indian banks

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Dividend
(In addition to 10% in April 2003)

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UTI Petro Fund	Rs. 1.20 (Rs 10/-)	25/06/03	Rs 15.92 as on 06/06/03
UTI Masterplus	Rs. 1.00 (Rs 10/-)	07/07/03	Rs 18.55 as on 20/06/03
UTI Mastergrowth	Rs. 1.20 (Rs 10/-)	18/07/03	Rs 16.42 as on 25/06/03
UTI Index Select Fund	Rs. 1.50 (Rs.10/-)	25/07/03	Rs. 14.81 as on 30/06/03
UTI Master Value Fund	Rs. 3.00 (Rs.10/-)	18/07/03	Rs. 23.23 as on 03/07/03

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UTIMF/0304/022

offer 5-6% interest to non-residents on their NRE (Rupee) deposits, dependant on the bucket of maturity. The yield on overseas deposits is between 1-2%. NRIs find NRE deposits more attractive as the interest income is not subject to Indian income tax. The incremental interest income—around 4%—has contributed for the phenomenal increase of NRE deposits. Flows into NRE deposits have increased by $966 mn, alone, in the month of April 2003. NRE deposits have stood at $15.789 bn at the end of April 2003.

To control arbitrage operations, RBI has capped the interest rates on July 17, 2003 on fresh Non-Resident (External) Rupee (NRE) deposits for 1-3 years at 250 basis points above the LIBOR (London Inter Bank Offered Rate)—a rate at which banks borrow/invest in different markets for short periods. The move is meant to kill the arbitrage opportunities that exist on account of the relatively higher interest rates that banks in India offer on NRE deposits. Though RBI does not admit the presence of evidence of significant arbitrage, the recent ceilings in interest rates on NRE (rupee) deposits is a clear signal of its unusual step that the country welcomes only deposits which wish to stay permanently, and not fair-weather friends.

But, the inflow may not decrease significantly as—NRIs find the gap in interest yield-around 2 to 3%—is still adequately attractive so long as they do not take the forward contract to hedge the exchange risk. In such a scenario, the NRE deposits are exposed to take exchange risk, if rupee depreciates at the time of maturity, compared to the prevalent exchange rate at the time of initial deposit. The trend has been not to enter forward contract and take the risk, as the rupee has been consistently becoming stronger against dollar. NRE deposit holders think forward cover is unnecessary, involving infractuous expenditure. More so, some of NRE deposits are interest insensitive.

Future perception

Domestic technology majors also share the same perception, in a different way, but in a stronger tone. Infosys, for instance, has hedged against rupee appreciation by taking a forward contract in July 2003 for $250 mn against the future receivables of its software services. Even importers believe that the rupee gains are going to continue for the future, so they think it unnecessary to hedge their import payables. This shows that NRIs, importers and technology majors hope rupee would appreciate, in other words, dollar would depreciate further strengthening the view of accelerated inflow and more forex reserves can be expected in the country for the days to come.

Government's debt restructuring

In a bid to reduce interest liability, Government of India has initiated steps to buy-back the high cost government securities, bearing interest rate between 8-13.85%, substituting them with cheaper paper carrying a far lower coupon rate ranging from 6.65 to 7.46%. In this process, 19 securities have been identified aggregating to a staggering figure—Rs. 1,00,483 cr bonds. To take advantage of soft interest regime, the government has devised a scheme which would be beneficial to the institutions as well reduce its own interest burden. This is a 'win-win' situation to both the parties. The ability to manage costs is critical, be it private or public sector. A first time debt restructuring in treasury management, on the part of the government is, indeed, a historic decision. Such bold steps are required even in the management of foreign exchange reserves as, presently, public often feel the government is not conscious of the cost in the decisions it takes. Government is, yet, to demonstrate the same will-power in containing the cost it bears in carrying the ballooning level of exchange reserves. Can we afford the cost? Dr. Arvind Pangariya, Professor of Economics and Co-director, Center for International Economics, University of Maryland says, "We earn less than 2% on the forex reserve but pay 8 or 9% on our external debt. Unless one can justify such a large reserve on the ground that it buffers against possible crisis, the extra payments on the debt are hard to defend."

Shift priority

In times past, the word 'foreign exchange' was always prefixed with the word 'precious' and anything that added to the foreign exchange was welcome with folded hands. The situation is no longer so. Adding burgeoning reserves is not a top priority. The relevant question, now, is the cost implication for carrying the swelling reserves. Far from being a sign of India's strength, such bulging reserves can be a sign that economic policies are not right. While the country pays an average of 8-10% interest to attract some of these reserves, much of these reserves are parked in US Treasury paper that yields under 2% annually. The difference is like an 'annual tax'—around $4 bn, paid by the economy for carrying the reserves each year. This amount is higher than the foreign debt inflows into the country each year.

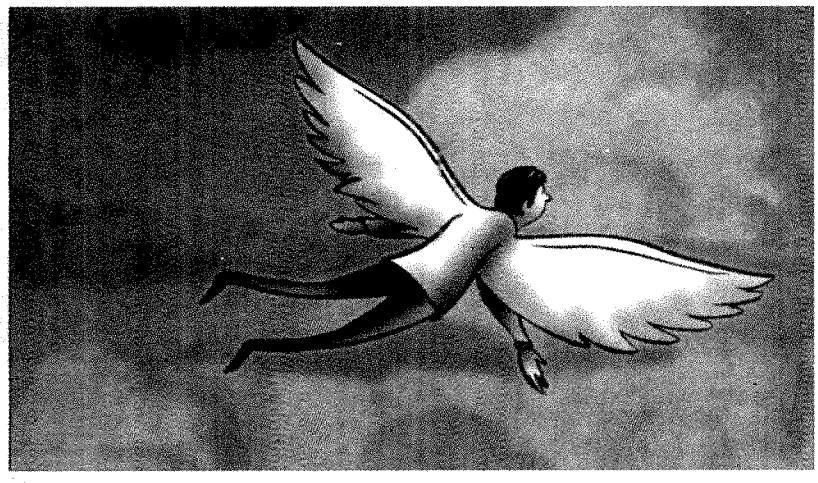
Accretion of reserves has been the priority of RBI, all along. It is a success story, till now, and deserves full marks for its performance. It is time, now, in the light of ballooning reserves to shift its priority from accretion to economizing costs in holding the reserves. This would be, indeed, a litmus test for its debt management, in terms of costs. Performance, on this score, would be a critical challenge as the reserves are poised to touch the magic mark of $100 bn, so confidently projected by the Finance Minister.

Reference # 1-2003-09-03

US CORPORATE BOARD ELECTION

On reforms path

With the SEC's current proposals on proxy rules, USA Inc.'s election of directors is becoming more democratized.



More than 18 months passed after the revelation of fraud at Enron. Many in corporate America followed suit in shattering shareholder confidence. US Government and the regulatory bodies, in the hope to restore shareholder confidence and inject discipline in corporates, started a series of reforms in the form of Sarbanes-Oxley Act. Good corporate governance fast became the priority of the regulators and stakeholders. Apart from the reforms initiatives, shareholders in corporate America were fighting for democratizing the process of electing directors. The reason: In America, the majority of director elections are uncontested. Candidates proposed by the existing board run unopposed with disagreeing shareholders being left with no other option than withholding their vote. All that the board needs is one vote from one friendly shareholder to ensure a director's election instead of getting a majority of the shareholder votes. Thus in many companies, questions were raised regarding the independence of directors and their functioning. Investor groups allege that the current cases of corporate wrongdoing might have been uncovered, if not avoided, if directors had been more independent and aggressive in questioning management. Also shareholders of many corporates allege that in most of the cases, the nominating committee rejects the shareholder nominees.

Given that elections of directors are run unopposed, is there any way for a disgruntled shareholder who wants his proposed candidate to get elected? Yes, of course, the shareholder(s) can launch a 'proxy fight'. This requires publishing and mailing of their own list of proposed directors to all shareholders, essentially turning the contest into a fight for control of the firm. This list of candidates competes with those on the firm's own proxy materials, sent to shareholders before annual meetings. The shareholders do have the facility of getting their candidate elected as director in the annual general meetings, but there is a bare minimum chance of the candidate getting elected for the board as the annual general meetings are mostly dominated by the presence of top management friendly shareholders.

On April 14, 2003, William Donaldson, Chairman of the Securities and Exchange Commission (SEC), proclaimed that "time has come for a thorough review of the proxy rules and regulations to ensure that they are serving the best interests of today's investors and fostering sound corporate governance and transparent business practices." The commission prompted by the thought that shareholder participation might encourage a greater sense of responsibility among owners and accountability among directors, proposed a limited form of enfranchisement. If implemented, shareholders would be able to put their own candidates on the firm's proxy materials, avoiding the expense involved in waging a proxy war. However, this right is likely to be granted only in exceptional circumstances.

At sixty still struggling

This is not the first time that SEC has made attempts to empower shareholders with the right to have access to company proxy materials for the nomination of directors. The commission has reviewed the issue of shareholder access to a company's proxy materials for the nomination of directors in the past (1942, 1978, and 1992). But each time, the commissioners have decided not to adopt any changes. As early in 1942, the commission requested the staff to review the proxy rules. On the submitted staff proposals the commission opined that "minority stockholders be given an opportunity to use the management's proxy material in support of their own nominees for directorships."

However, the commission did not adopt rules to provide this access. Again in 1977, during its broad review of shareholder

communications, the commission, without formally proposing rule changes, requested comment on a number of issues, including whether "shareholders should have access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors." Subsequently, after reviewing the comments it received, the commission adopted a requirement that companies state whether they have a nominating committee and, if so, whether the nominating committee will consider shareholder recommendations.

The commission continued its silence on shareholder access to company proxy materials. Again in the broad proxy revisions adopted in 1992, the commission revisited the shareholder access issue in connection with amendments to the bona fide nominee rule, which states that no person shall be deemed bona fide nominee "unless he has consented to being named in the proxy statement and to serve if elected." One major reason for the SEC for not revolutionizing the proxy process in all the three occasions was the general fear among the business community that any major reform will affect the functioning of the board.

The new proposals

The staff report released on July 15, 2003 recommended that the proxy process be changed in two areas—disclosure and the nominating process. The recommended rules require companies to disclose the process they go through to select directors. The recommendation would also require disclosures on shareholder communications, including the company's process for determining which communications are sent to board members, the number of times individual board members met with shareholders, and any action taken as a result of shareholder communications. And it recommended that a company be required to let investors use its proxy to nominate directors if the corporation has ignored proposals endorsed by a majority of shareholders or has had a large percentage of shareholders who routinely withhold their votes.

The disclosure recommendation would require that proxy materials include such information as the nominating committee's criteria for director candidates, its policy on shareholder candidates, and whether the committee has chosen not to nominate a candidate from an investor meeting minimum ownership thresholds. If the committee has passed on a shareholder candidate, the committee would have to explain why and whether each member of the committee agreed that it was in the company's best interests. The nominating shareholders would have to constitute a certain percentage of investors, with proposals ranging from 1 to 5%. Also, they would have had to be shareholders for a specified time, probably a year or more. But the question is, will retail shareholders benefit from this criteria?

For all practical purposes, this criteria may act as an impediment for the retail shareholders as it is really difficult for them to pool up the shareholders for becoming eligible to nominate directors. The point here is that although it may not be impossible for them to meet the proposed criteria, definitely it is difficult and a costly exercise unless

Shareholder Proxy: A Primer

- A shareholder proposal is the recommendation or requirement that the company and/or its board of directors take action, which the shareholder intends to present at a meeting of the company's shareholders. The proposal should state as clearly as possible the course of action that the shareholder believes the company should follow. If the proposal is placed on the company's proxy card, the company must also provide in the form of proxy means for shareholders to specify by boxes a choice between approval or disapproval, or abstention.
- In order to be eligible to submit a proposal, the shareholder must have continuously held at least $2,000 in market value, or 1% of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date he submits the proposal. The shareholder must continue to hold those securities through the date of the meeting.
- Each shareholder may submit no more than one proposal to a company for a particular shareholders' meeting.
- If the company intends to exclude a proposal from its proxy materials, it must file its reasons with the Commission no later than 80 calendar days before it files its definitive proxy statement and form of proxy with the Commission. The company must simultaneously provide the particular shareholder with a copy of its submission. The Commission staff may permit the company to make its submission later than 80 days before the company files its definitive proxy statement and form of proxy, if the company demonstrates good cause for missing the deadline.

  The company must file six paper copies of the following:

  a. The proposal;

  b. An explanation of why the company believes that it may exclude the proposal, which should, if possible, refer to the most recent applicable authority, such as prior division letters issued under the rule; and

  c. A supporting opinion of counsel when such reasons are based on matters of state or foreign law.

Source: www.sec.gov

they get support from any major shareholder(s). The other groups that are left over are pension funds, institutional investors, other shareholder activist unions who hold substantial quantity of shares. Institutional investors, who have ready-made access to the board of directors, may not be motivated to have a candidate of their own in the board.

Moreover, large institutional investors generally have presence in the board of directors. Les Greenberg, Chairman of Committee of Concerned Shareholders, a US-based organization opines, "Employing nominator criteria of 3% or more stock ownership threshold is impractical and, like non-binding shareholder proposals, would result in a sham upon the investing public. Mutual funds have too many potential conflicts of interest and too much potential of legal exposure to participate in nominating directors. Forming and maintaining 3% groups will be nearly impossible except for a few activist unions. Those unions have the resources to engage in only a few proxy contests. Institutional investors do not have the interest, desire and/or resources to seek director accountability on such a scale."

Fears are running high among the corporates as they feel that, shareholder-nominated directors could make it harder for them to run their companies

Fears of the corporates

Fears are running high among the corporates as they feel that shareholder-nominated directors could make it harder for them to run their companies. Their contention is that boards might be paralyzed by a few dissidents or individuals obsessed with one issue. With regard to the dreaded corporate raider, SEC Chief Donaldson was quoted in *The Washington Post* that SEC will make sure that safeguards are in place to prevent the rules from being used to mount a takeover of a company or from upsetting the mix of expertise and backgrounds some corporations strive hard to create on boards. Accordingly, as per the proposed rules, shareholder-nominated directors would be limited in number, possibly even to one per board. To this end, corporates need not fear of any raiders.

In addition to these concerns, corporates also argue that they have been so swamped with changes mandated by the Sarbanes-Oxley legislation enacted last summer and new rules that have been proposed by industry's two self-regulatory groups, the New York Stock Exchange and the National Association of Securities Dealers (NASD), that they need more time before regulators impose additional regulations. Also, there is the issue of escalation of cost of director election, if shareholders are allowed to propose their nominees in the company proxy forms. Their argument is baseless as it is the shareholders' money that they use to get their candidates elected to the board. Under current rules, shareholder has to spend his own money to see to that his nominee is elected. "Regarding the complex issue of determining the rules for director nominees to appear in the company-paid proxy, one strategy to consider is letting shareowners decide this by vote at each company," says Mark Latham, Founder, The Corporate Monitoring Project.

Looking at the way corporates reacted to these proposals, there is a high probability of their opposition, they might even challenge the authority of the SEC to amend rules regarding proxy. In *The Washington Post* the SEC Chairman Donaldson opines, "The goal of the new rules will be to create a system in which the board hires a chief executive, not the other way around. The new rules are expected to come into existence by August or September this year. The track record of the regulatory agency in amending the proxy rules has been not very positive, but this time in the current days of low shareholder confidence, the regulatory agency should successfully set-off the reforms in director elections. In addition, when SEC seeks to democratize the director elections, can it learn any lessons from the recall system existing in the United States general elections?

"Regarding the complex issue of determining the rules for director nominees to appear in the company-paid proxy, one strategy to consider is letting shareowners decide this by vote at each company.

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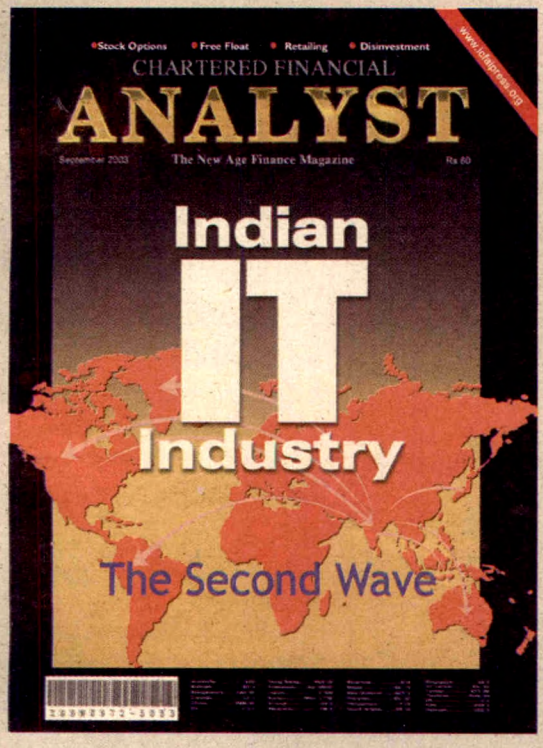
Founder
The Corporate Monitoring Project
www.corpmon.com"

Can the regulatory agency think of proposing a rule enabling shareholders to recall directors who fail to discharge their duties? Can SEC, in future, think of a system wherein, if a given percentage of shareholders opine that a particular director has failed in discharging his duties or has lost his independence, a rule be made wherein he is asked to fight an election and gather at least 50% of the polled votes failing to get so, be recalled? Nevertheless, SEC has lot more to do in future with regard to proxy rules.

Shashidhar Mishra

Reference # 1-2003-09-04



Indian IT Industry

The Second Wave

The Indian software industry has come a long way since its inception in the 1980s. It has been successfully dealing with challenges and achieving a steady growth rate; however, in the initial years of the 21st century, it encountered new challenges—competition and reduction in revenues. Will the Indian software industry achieve the target of becoming a $50-bn industry by 2008?

In the last decade, the software industry has grown at an impressive Compounded Annual Growth Rate (CAGR) of nearly 50%. The impressive growth rate continued in the fiscal years 2000 and 2001-02 (though not at a CAGR of 50%), despite the worldwide economic slowdown and September 11 incident. The industry grew at 26.5% and 31.7% in 2000-01 and 2001-02 respectively. The gross annual revenue of the Indian software and services industry is expected to reach $13 bn in the financial year 2002-03 from its earlier $10 bn during the financial year 2001-02. Analysts and industry observers have predicted that by 2008, the total annual revenue of the Indian software and services industry would reach $50 bn.

Not only that, even major global software companies like Microsoft and Oracle are bullish about the Indian software industry. Microsoft has viewed India as one of the top three emerging markets along with China and South Korea. It has already embarked on the expansion plan of its India Development Center (IDC) in India and has already invested $150 mn on its IDC and has plans to invest additional $500 mn in the next few years. Oracle also has plans to double its headcount in India from its current 3,200 to 6000 in the near future. Its CEO, Larry Ellison, while addressing a recently held summit called 'Practices for Progress', commented, "India's specialty is in professional services such as software."

Seeing the growth of the Indian software industry, global IT vendors such as Accenture, Electronic Data Systems (EDS) and IBM Global Services (IBM GS) have rushed to set up their software development centers in India. Nasscom has reported that the growth rate of these companies is almost twice as fast as Indian IT companies. *The Economist* has commented in a recent article that there has been a shift, albeit slowly, of the geographic location of IT industry from Silicon Valley to new destinations such as India.

All these indicate that everything is perfect for the Indian software and services industry. But does it mean that in the coming years the picture will remain the same? In the last quarter of the financial year 2002-03, the earnings of Infosys, one of the top five Indian software and services companies fell by as much as 32%. In the first quarter of the financial year 2003-04, Wipro's (another one among the top five companies) net profit declined by 9% over the last quarter of the previous financial year. In this new scenario, what lies ahead for the Indian software and services companies?

The new equation

By the end of 2000, Y2K projects were no longer there. With the loss of a high revenue-generating stream, the revenue generating capacity of the top Indian software firms declined. They realized the importance of gaining sector-specific domain knowledge. While TCS and Infosys concentrated on Banking and Financial Services (B&FS) domains, Wipro and Satyam concentrated on telecom and automated systems in transport manufacturing domains respectively. Further, with the Internet boom, there was a substantial increase on the number of software-related collaborations with US firms in designs of Web-based systems. Many of the firms began to develop customized software for dotcom companies in the areas of e-services, eSCM and eCRM.

In 2001, with the burst of the dotcom bubble, and collapse of the telecom and wireless businesses in the US and Europe and the global recessionary condition, there was a dramatic cut in IT spending. The Indian companies faced downward pressure in the billing rates. As a result, the revenues of the Indian software firms, which were dependent on outsourcing, fell dramatically. Many firms, especially the medium and the smaller ones, which were established during the boom period of mid-1990s exited during this period.

Due to the pressure to reduce costs to sustain the downturn, the US firms gave more importance to returns on every dollar spent by them. There was also a shift from the onsite projects to offshore projects. The hourly rate for work done onsite was high (around $60-70), compared to that of offsite (around $25-30). The Tier-I Indian software firms turned this adversity into opportunity. They concentrated on brand-building exercise, instead of investing on development centers and recruitment. This they did by adopting an aggressive marketing campaign to make India, an ideal outsourcing location. The opening up of marketing offices at the clients' countries also hastened up. HCL Technologies entered into a strategic alliance with Toshiba Information Systems Corporation (Japan) to set up a dedicated offshore development center for developing embedded software for the Japanese company.

During the same period, some of the top IT firms like Wipro, Infosys and TCS also reinvented their business model. They tried to move up the 'value chain'. For the first time, they tried to focus on the high-margin segments of IT consulting or systems integration. Systems integration consists of designing and configuring the different IT platforms on which different software packages run. Instead of doing only low-end jobs of code writing and programming for application packages, the premier software firms of India turned to areas like embedded software. Wipro managed to secure a $70 mn systems integration order from the Lattice Group against a strong bid from Accenture. Wipro Infotech, part of Wipro group, also announced to offer high-end business applications and e-commerce solutions for the domestic market. Though the revenues from the high-end segments were high (compared to data conversion, installation and maintenance), so were the risks. Some even entered business process outsourcing arena to broaden their revenue streams. Wipro picked up minority stake in Spectramind, a call center.

On the other hand, the top Indian software firms also looked into areas like Information Services (IS) Outsourcing and packaged software support and installation. They also entered into other verticals such as insurance, retail, manufacturing, healthcare and government. Some of them also broadened their geographic areas by entering into countries like China, Japan, Malaysia, South

"Technology and marketing knowledge transfer to India may help maintain the sustainable growth prospects for the Indian software industry."

Dr. Mahesh S Raisinghani

Program Director
eBusiness and Faculty Member
Graduate School of Management
University of Dallas

Africa and Australia, and the countries in Western Europe. Siemens Information Systems Ltd., entered into UK, Germany, Scandinavia and South Africa. I-flex Solutions entered China, European Union and Latin America. According to Nasscom, Indian software industry earned $140 mn from software exports to Japan in 2000-01.

However, some other new trends were also seen during this period of slowdown. Companies like Infosys also set a unique trend in corporate governance; it voluntarily made disclosure of revenues and per share earnings growth. Mergers and Acquisitions (M&A) also took place as the second and third tier Indian software companies were acquired by either Tier-I Indian software companies or MNCs. While HCL Technologies acquired Deutsche Software, Infosys made strategic investments in Purple Yogi, and in a few other companies.

Indian firms also entered into partnerships and alliances with global software companies. Recognizing India's emergence as a leading name on the world's software map, Microsoft formed an alliance with Infosys. The alliance provided Infosys access to Microsoft's vast base of global customers. Collaborations with companies like Microsoft generate more number of orders and provide easy access to a broader customer base. The Indian software firms, especially the medium and smaller firms also started price war, depending on the project size, i.e., lowering their billing rates to hold their existing customers and attract new customers. Even the Tier-I Indian software firms followed.

IT Services Spending: Regional Shares, 2002-03

	IT services spending (US $ bn)	India's exports (US $ mn)	India's market share (%)	Relative dependence ratio	Share in India's exports
North America	171.1	6,685	3.92	1.4	67.7
Western Europe	109.6	2,103	1.92	0.7	21.3
Japan	34.9	193	0.55	0.2	2.0
Latin America and Rest of World	17.5	583	3.33	1.2	5.9
Asia Pacific	16.0	311	1.94	0.7	3.2
Total	349.1	9,875	2.82		100

Note: Relative dependence measures the region's share in Indian exports vis-à-vis the region's share in world IT services spending. A ratio less than 1 indicates a possible underpenetration of the market.

Source: Nasscom, IDC

The challenges

The American firms till 2001 outsourced their software requirements from the Indian firms that would give them cost advantage. However, by 2002, their outsourcing became 'strategic' in nature. Instead of considering costs only while outsourcing, the American firms started to give more importance to parameters such as return on investments and end-to-end service offerings. As outsourcing became 'strategic', the decision-making on these deals shifted from CIOs to CEOs and CFOs. Strong client relationships, good networking and good brands became the key to win bids. The Tier-I Indian firms were better placed compared to the medium-sized Indian software firms in bagging big deals. However, the Tier-I companies were still no match to the global IT vendors such as Accenture, IBM and EDS. In their efforts to compete successfully against the global IT vendors, the Tier-I Indian software firms started initiatives towards becoming a global company and a global brand. In that direction, they hired people from across the world. Wipro hired several experienced people from MNCs such as, Merrill Lynch and EDS, among others. It recruited an ex-chief technology officer of Merrill Lynch's global technology services to lead the securities solutions practice, part of Wipro's financial solutions group. The Indian companies also worked hard to broaden their client base and were not dependent on a few top clients.

When volume growth remained sluggish and billing rates were under pressure, Indian software companies too went in for a cost-cutting exercise. They improved employee utilization, improved productivity through reusable components, gave variable salaries, and controlled general and administrative costs. They also moved towards fixed-price contracts in the maintenance and support functions to stabilize operating margins. On the other hand, with global recession and US firms increasingly outsourcing their IT requirements from Indian software firms, there had been a considerable loss in jobs. This led to a backlash against Indian software professionals in countries like Malaysia and Holland.

Meanwhile, global giants such as Microsoft and Oracle ramped up

> **The move of the global IT vendors suggests that India is well on the way to becoming a preferred IT destination and that the cost factor is a definite key to this development.**
>
> **Ashok Kumar**
> *CEO, Lotus Strategic Consultants*

their Indian presence considerably and in 2003, global IT vendors such as IBM, Accenture and EDS set up their software development centers in India. Accenture has been aggressively going after outsourcing both technology and business process. The company is trying to build offshore delivery capabilities related to this. Accenture in 2002 merged its technology and outsourcing business, which grew by 33%. That meant competition is now no longer restricted among Indian software firms only. IBM also is building a metrics system for customers with an in-built offshoring template that would allow it to estimate how to price various tasks. Rather, competition in the future will be at two levels, domestic and global. Dr. Mahesh S Raisinghani, Program Director of eBusiness and Faculty Member at Graduate School of Management, University of Dallas opines, "this increases competition and helps keep everyone on their toes. It may push a higher CMM ranking to improve efficiency and effectiveness by the various software companies and may also help to check prices."

Competition is not only in getting business but also in issues related to manpower. In India, Accenture has been hiring aggressively for its IT offshore development center, and some analysts have said that they are poaching employees from the Tier-I domestic firms with offers which are 20-30% higher than what domestic firms pay. On the other hand, for Indian firms to cut cost, the increase in salaries would not be very high (10-11%).

It seems that there is going to be a huge gap in the supply and demand of quality software professionals. Nasscom's President, Kiran Karnik, has recently said at a meeting of Technology Information Forecasting and Assessment Council of Department of Science and Technology (India), "the manpower we have was good enough for helping India become IT service provider and back-office of the world, but to become a knowledge leader of the world we need professionals qualified enough to take us there."

Added to that, there is also the 'China factor' and competition from other low-cost countries like Philippines and Russia, because of which the cost advantages that the Indian firms enjoy are fast becoming blurrer. While China has scaled up its software strengths rapidly (currently growing at a rate of more than 120% year-on-year), and is now focusing on English language, the English-speaking Philippines which has more American influence than the British-ruled Indians has the chance to grab low-end services of maintenance and installation. Makarand Padalkar, Chief of Staff, I-flex Solutions, says, "The continuing squeeze on technology spends along with the emerging competition of the newer players like China, Philippines, Ireland and East European countries means that low value-added work which depended purely on arbitrage provided by skilled labor would narrow down with time. This will further accentuate as China prepares its own army of skilled, English-speaking personnel in the coming years." China's exports on software and services is expected to reach $27 bn by 2006. On the other hand, Russia has skilled software professionals who are capable of doing high-tech work. A UBS Warburg report said that Russia has 55 engineers per 10,000 people, which is ahead of India and that in 80% of the Russian IT firms (300) at least 10% employees are Ph.D.s. In addition, the exports of the Indian software and services industry registered a growth rate of only 18% in the financial year 2002-03.

Low-cost Software Developing Countries

Leaders	Up and Comers
India	Brazil, Caribbean, Egypt, Estonia, Latvia, Lithuania, New Zealand, Singapore, Ukraine, Venezuela
Challengers	**Beginners**
Canada, China, Czech Republic, Hungary, Ireland, Israel, Mexico, Philippines, Poland, Russia, South Africa	Bangladesh, Bulgaria, Cuba, Ghana, Korea, Malaysia, Mauritius, Nepal, Senegal, Sri Lanka, Taiwan, Thailand, Vietnam

Source: Gartner Inc.

> **"Indian companies have the capability and strong financial back-up to work with global players."**
>
> **Makarand Padalkar**
> *Chief of Staff, I-flex Solutions*

After having worked with Indian firms for over two decades, foreign clients too are becoming smarter. Most of them are now able to calculate the margins of the Indian firms. The foreign clients now also know how to renegotiate the prices downwards. Obviously, issues have been raised as for the Indian software firms' ability to remain competitive against the global IT vendors; how long the Indian software firms can peggy back on global IT outsourcing and cost advantage and whether they would be able to succeed in moving up the 'value chain' in the long-term.

A Brief History of Indian IT Industry

The early years

The Indian software firms like Tata Consultancy Services (TCS) and Computer Maintenance Corporation (CMC), which is now a part of the Tata Group, were engaged in the development of software programs since the 1970s. They were then catering mostly to the big domestic companies and the Indian subsidiaries of the MNCs, who were earlier served by IBM (IBM exited India in 1977). But the size of the software business in the domestic market was not big enough for these companies to generate revenues year after year in the 1970s. As a result they had to look towards the foreign countries to generate revenues. However, it was not easy for the software companies to bag projects from the foreign countries. Because during that time, foreign countries were skeptical about the quality and on-time delivery of products done by Indian companies. This made the Indian firms to execute projects restricted to data conversion. That too at the premises of the foreign clients (onsite).

In the 1980s, technological changes in the IT industry offered new opportunities for the Indian software firms. Mainframe computers lost their popularity to Personal Computers (PCs). The benefits of PCs made companies in the US and Europe to migrate from the mainframe platforms to the PC platform. Many of the tasks involved were routine which made the American firms to outsource. But this helped the Indian firms to diversify their revenue streams, in addition to that of installation and maintenance of the older legacy systems.

The big opportunity and potential to earn huge revenues attracted firms like Wipro, HCL and others to enter the software business. Firms like Infosys and Patni Computer Systems also came into existence during that time. These firms also acquired considerable expertise in various types of IT-related work. The excellent skill sets possessed by the Indian engineers and the 12-hour time difference between India and the US attracted a few foreign companies like Texas Instruments to locate their software development centers in India. In addition, these foreign companies realized the cost advantage of using the services of Indian engineers.

The heydays

In the early 1990s, globalization and competition, and reputation of the Indian engineers as excellent software programmers increased, and more number of MNCs started to set up (Indian subsidiaries) their software development centers in India to meet their global software needs. Companies like British Telecom, Digital Equipment, AT&T and Northern Telecom to name a few, started their software development centers in India during this period. These centers acted as low-cost outsourcing centers, where Indian engineers developed software. This type of business model gave rise to a new type of software services model, called 'offshore model', also known as 'turnkey projects'.

Seeing the benefit of this new trend, the Indian software firms also started setting up offshore development centers in India dedicated to specific US clients. The advantage was: Higher margins on projects, as the billing rates were higher. However, the Indian companies were devoid of big value deals. Still, the composition of onsite relative to offshore projects was very high for the Indian software firms. To win more projects from the US and to compete with the big US IT vendors, the Indian software firms realized the need to move away from being bracketed as low-price, low-quality producers to competitive-price and high-quality producers. The Tier-I companies such as TCS, Wipro and Infosys adopted the ISO 9000 international standard for quality management and assurance.

In the mid-1990s, US companies faced a new problem—Year 2000, called as Y2K problem. Y2K projects were mainly executed on sites at the clients' premises. However, US companies experienced a huge shortage of software programmers to do such projects. Even the willing ones charged high rates. As a result, Indian software companies got large number of outsourcing projects from American companies. Though the Indian software companies were only involved with the computer programming and code-writing part of the Y2K projects, the success of the Indian firms proved their American clients that they could give the same quality work as that of IBM and EDS, at a fraction of their costs.

By 2000, the Tier-I Indian software firms like TCS, Wipro and Infosys, though gained expertise in onsite model, with the increasing competition from the established players and upstart companies (both foreign and local) in outsourcing business (majority of them were dependent on onsite projects), they had to devise a strategy to differentiate themselves from the rest. As a first step, they got actively involved in the setting of certification norms for service production, like the Capability Maturity Model of Carnegie Mellon University's Software Engineering Institute. Few of them like TCS, Wipro, Infosys and Satyam even opened marketing or representative offices in the US, where majority of their clients were based. The reason was to increase their presence in the clients' countries.

The strategies

People from the software industry, Nasscom and the analysts have different views on the challenging issues faced by the Indian software industry. Commenting on the competition, Ashok Kumar, CEO, Lotus Strategic Consultants, opines, "the move of the global IT vendors suggests that India is well on the way to becoming a preferred IT destination and that the cost factor is a definite key to this development." Sangeeta Gupta, Vice-President, Nasscom, opines, "with India increasingly becoming a hub for innovation, research and development activities, we are happy that the true potential of Indians is being finally realized. This would indirectly benefit in enriching the economy and build it as a knowledge economy." On the other hand, Padalkar, though

has similar views has a word of caution. According to him, "there is no doubt that India has emerged as the preferred destination for global offshore outsourcing. But at the same time, competition for Indian companies will get tougher. As offshore becomes mainstream, Indian firms are beginning to lose some of their price advantage."

To counter the global IT vendors and compete with the low-cost countries, Indian software companies are also getting aggressive. Ashok Kumar also says, "resting on the cost and language advantage which has been the initial driver for Indian IT companies could prove counter productive." They are now more aggressive in diversifying their revenue streams, instead of depending only on their traditional sources. They are also trying to hasten up the process of moving up the value chain, which they had started earlier. Padalkar opines, "Indian companies have the capability and strong financial back-up to work with global players. One way to do that would be by opening new revenue fronts like BPO, infrastructure outsourcing and package implementation services. They need to go beyond custom development and maintenance work. It is time for the Indian software industry to increasingly focus at delivering higher value for providing business solutions, which requires getting into domain specialization, developing products and so on." Jacob Varghese, Strategic Marketing, Wipro Technologies, opines, "the new strategic approach will be to move up the value chain and deliver significant value additions to the client. This will help position companies such as Wipro Technologies as an end-to-end solution provider, a technology consultant, rather than as a company offering mere technology solutions across different domains—hence competing with the Big 4." Sangeeta Gupta opines, "Indian firms need to take care of the issues related to HR, which would be affected the most with multinationals promising better prospects." Another trend seen is the concept of consortium model, with small companies coming together to pool their expertise in their respective areas while bidding for projects.

More than half of the total software development centers that have attained the SEI-CMM Levels 4 and 5, the second highest and the highest levels in CMM, respectively, are now based in India. Will it be enough? Craig Baty, GVP and Chief of Research, Global IT Management Sector, Gartner, commented, "Today, the Indian advantage is experience and project management coupled with language and a solid reputation. To compete with the emerging markets they should look at partnering with lower cost providers/countries, and add value to their base offerings. Indian service providers must continue to develop and adopt true market intelligence and competitive marketing strategies."

However, product development also requires Indian companies to take greater risks and make larger investments on research and development. It also needs for companies to have much greater understanding about the emerging IT platforms and technologies. For that they require more number of software architects. Software architects help the developers to understand the system and allows enterprises to design better systems, and increase the reuse of frameworks and components and also reduce the cost.

A point in favor of the Indian software companies is that these global IT vendors need to go through the learning curve before they can attain and match the expertise of the Indian firms in offshore outsourcing.

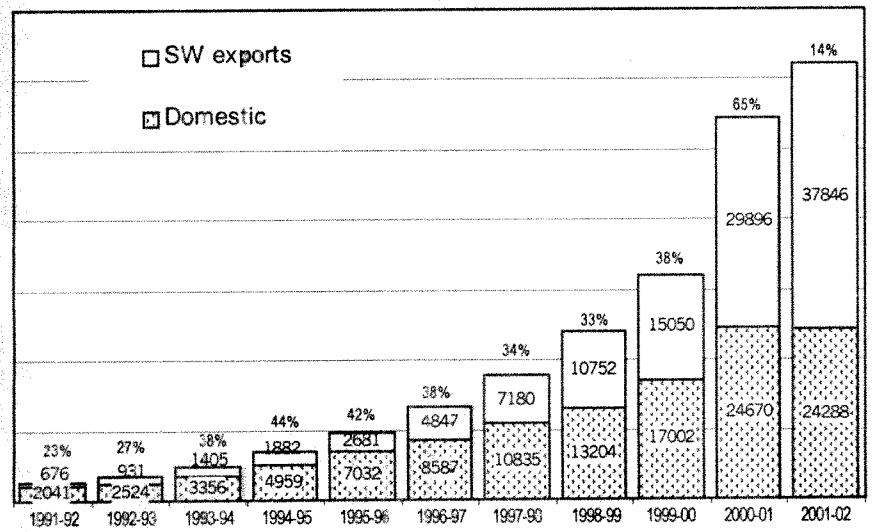
Structure of Indian Software Exports Industry

Annual Turnover (in Rs. cr)	No. of Companies 2000-01	2001-02
Above 1,000	5	5
500 - 1,000	7	5
250 - 500	14	15
100 - 250	28	27
50 - 100	25	55
10 - 50	193	220
Below 10	544	2,483

Note: In 2001-02, companies under Rs. 10 cr revenues include non-Nasscom member companies.

Source: Nasscom

A Decade of Indian IT Industry: Overall Industry Segmentation



Source: Dataquest

Dr. Raisinghani also agrees. He says, "the global players have a longer learning curve with respect to the cultural and socio-political issues in India. This put them at an initial disadvantage although they seem to have an upper hand with the clients/marketing contacts in the West. Nandan Nilekani, CEO, President and MD of Infosys, commented in the recent Q1 results' press conference of Infosys, "even though the global systems integrators are competitive, they do not have as much credibility with the offshore Global Delivery Model (GDM) to meet Infosys. They need to first replicate the GDM and not hiring." Commenting on this, Varghese opines, "There are significant challenges facing global majors in terms of incorporating offshore based human resource development, quality processes and expertise in managing globally distributed software development."

Another way with which domestic firms could keep competition at an arm's length is through acquisition. Recently Wipro acquired the global energy practice of American Management Systems for $26 mn. Though the process had started earlier, we are yet to see big-ticket acquisitions from the cash-rich Indian software firms, similar to that of EDS acquiring consultancy firm, A.T. Kearney, and IBM acquiring the consulting business of PricewaterhouseCoopers.

Also if the Indian software firms are to excel in the global market, they have to emulate the model adopted by global majors like Unilever, Coca-Cola and Nestlé. They need to build their brands, because brands are everlasting, as we have seen of the brands like Coke, Kodak and others. In this context, in an address to the government and industry, organized by the Confederation of Indian Industry on the subject of 'Making India Globally Competitive', N R Narayana Murthy, Chief Mentor and Chairman, Infosys commented, "the country is lagging behind in terms of creating a global brand. To succeed in brand-building, Indian software firms need to strengthen their focus on marketing and add new product lines." Dr. Raisinghani opines, "branding, pricing strategy, quality of products/service and infrastructure are some of the issues which need to be addressed."

Some companies have started the process of becoming global players. Scale would also help them to get large-size deals. TCS plans to become a $7-bn software services organization by 2010. In that direction, the company plans to have a manpower base of around 70,000 and open many more software development centers across the world. Infosys has opened a Leadership Institute in Mysore to make future leaders while Wipro has hired experienced people from across the globe to head its different divisions.

Indian Software and Services Exports

(US $ bn)

Key Services Lines	2001-02
Software and Services	4.95
IT Consulting	0.05
System Integration	0.15
Custom Application Development and Maintenance	2.65
Network Consulting and Integration	–
IT Training and Education	–
Hardware Support and Infrastructure	–
Packaged Software Support and Installation	0.30
Processing Services	–
IS Outsourcing	–
Application Outsourcing	1.75
Network Infrastructure Management	0.05
IT Enabled Services	1.49
R&D Services	1.21
Product Development and Design	0.30
Embedded Software	0.91
Total	7.65

Note: The above classification of software service lines is tentative. In general, there is no commonality in definitions of service lines by software companies.

Nasscom will endeavor to standardize the classification schema on internationally accepted standards in order to better track the growth and market share of Indian companies.

The above classification and revenues are likely to change in coming years as more granular data is obtained from software companies.

Source: Nasscom

Indian software firms can also learn from I-flex Solutions, which has done wonders in the product arena. It has become the top banking software product company in the world. According to Padalkar, "I-flex Solutions' strength and competitive advantage lies in specializing and concentrating on a specific vertical to achieve success. Creating a specialized product for a specific vertical has a much greater chance of success than trying to create a product that addresses a horizontal market. We also chose first to sell our product to banks in emerging markets like Africa to get enough reference sites in order to enter mature markets like US and Europe. I-flex's marketing team hired locales, and partnered with local vendors. It

Indian Software Exports: Delivery Models

(in Rs. cr)

	1999-2000	2000-01	2001-02	2002-03
Onsite	9,850	15,900	16,500	18,500
Offshore	5,950	10,950	18,500	27,500
Products and Unclassified	1,350	1,500	1,500	1,500
Total	17,150	28,350	36,500	47,500

Source: Nasscom

also partnered with industry leaders like Accenture, HP, IBM and others to leverage its mutual strengths and expand its reach and penetration in international markets."

The best way for Indian companies to tackle the issue related to backlash against Indian software professionals in foreign countries is to get identified as local companies and hire more local people, hire cross-cultural expertise, support and encourage local exports and form local alliances. Few have also adopted the strategy of not disclosing the names of new clients to avoid backlash over the outsourcing issue in the clients' countries. Sangeeta Gupta opines, "outsourcing is irreversible and benefits will be better understood once the US economy picks up." Dr. Raisinghani has an interesting viewpoint. He says, "I think this as the borderless world and the global economy. So movement of professionals across national borders is a phenomenon that cannot be curtailed and may be beneficial for all. Technology and marketing knowledge transfer to India may help maintain the sustainable growth prospects for the Indian software industry."

Conclusion

In the past, Indian firms were successful because they constantly scanned the external environment to look for changes and reacted quickly, in order to remain ahead of the competition curve. In the early years, they quickly realized the benefits of exports. By the mid-1980s, Indian software industry realized the reputation building through low value-added work (first stage of development). Then by 2000, when they found the advantages of offshore, the rates were very less compared to onsite ($20-25 vs. $60-70), they switched to that and started offshore-customized software development (the second stage of development). With increased competition, the Indian firms are currently trying to improve value addition through offshore package development (the third stage of development).

"We continue to believe that we have an opportunity right now like we have never had before to be one of the top 10 global IT players."

Jacob Varghese
Strategic Marketing
Wipro Technologies

It is not easy. Most of the Indian firms lack depth and width in domain knowledge and do not have strong customer centricity. Customers these days want solutions not software. Instead of restricting themselves to providing applications only, they have to identify problems in clients' business functions and provide solutions. In other words, they have to take care of all the IT aspects of the clients, as the global IT vendors do. They have to convey long-term vision and strategy to the clients. Varghese opines, "The strategy is to increase the depth of engagement with each client, to manage a higher percentage of his IT budget every year to achieve critical mass and to build multiple services, so that we are not only engaged with CIOs but also with others." Not only that, Indian companies also need to take care of Intellectual Property Rights related issues. They have to work more on gaining considerable visibility in the US markets, which can only be achieved through strong brand equity. A strong brand equity will help Indian firms to have easier access to boardrooms where outsourcing decisions are made or influenced. The Chinese brands like Legend in computers and Haier in appliances are great examples from which Indian software firms can get inspiration. If the need arises they have to partner with foreign companies to remain ahead.

"Indian firms need to take care of the issues related to HR, which would be affected the most with multinationals promising better prospects."

Sangeeta Gupta
Vice-President
Nasscom

To bring about the next wave of IT revolution in the country, Indian companies, Nasscom and the government have to work in a collaborative manner. A healthy and domestic vibrant industry is also a must. In this context Sangeeta Gupta says, "Nasscom would focus more on building the 'India Inside' and 'Made in India' brands. It would also focus on catalyzing the domestic market by having 'user industry' and Indian IT industry especially the SMEs understand the requirements." Varghese views, "We continue to believe that we have an opportunity right now like we have never had before to be one of the top 10 global IT players." Indian software firms can indeed bring about the second IT wave provided they have the right vision, the right capabilities, enterprise-wide process maturity, more customer focus and proper execution.

Anindya Roy

Reference # 1-2003-09-05

A guide to help you invest wisely

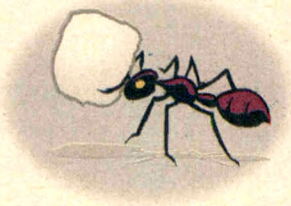
Take the cue from **nature**

The zebra foal gets a head start in life as it stands up within an hour of birth.

Invest early.

To get a head start in life.

Ants regularly store more food than they consume.



Invest regularly.

To create wealth over a period of time.

The baby kangaroo is well protected and safe in its mother's pouch even when she leaps.

Ensure safety.

By investing in schemes that provide adequate safety.

The squirrel hides its nuts in different places in the woods.

Diversify investments.

To minimise risks and maximise returns.

The crane stands absolutely still in water for hours together for its catch.

Be patient.

Stay invested to reap better rewards.

The giraffe feasts on the food stored in one of its four chambers, when it is hungry.

Ensure liquidity.

To get your money back when you need it most.

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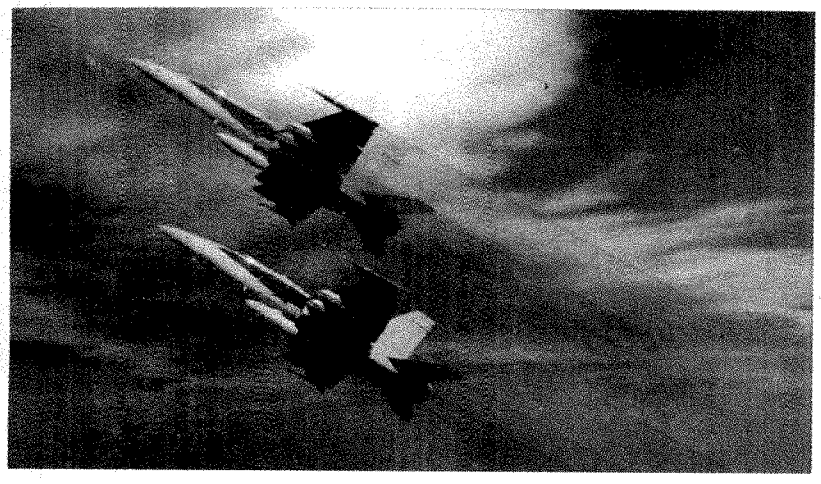
Issued in the interest of investors.

SOFTWARE INDUSTRY

Is India ready for challenges?

With so many companies acquiring the CMM and ISO level certifications, there is a need to find out a new USP to stay competitive, says Dr. V V L N Sastry, Country Head, Firstcall India Equity Advisors Pvt. Ltd.



The success of Indian firms in outsourcing is due to various factors like –

Large human resource

Every year, approximately 19 million students are enrolled in high schools and 10 million students in pre-graduate degree courses across India. Moreover, 2.1 million graduates and 0.3 million postgraduates pass out of India's non-engineering colleges and the country currently graduates around 110,000 computer science students a year.

While 2.5-3% of them find jobs in other fields or pursue further studies abroad, the rest opt for employment in the IT industry. If the flow from high schools to graduate courses increases even marginally, there will be a massive increase in the number of skilled workers available to the industry.

Indian education system

The Indian education system places strong emphasis on mathematics and science, resulting in a large number of science and engineering graduates. Mastery over quantitative concepts coupled with English proficiency has resulted in a skill set that has enabled the country to take advantage of the current international demand for IT.

Quality manpower

Indian programmers are known for their strong technical skills and their eagerness to accommodate clients. In some cases, clients outsource work to get access to more specialized engineering talent, particularly in the area of telecommunications. India also has one of the largest pools of English-speaking professionals.

Government policies

The Indian Government recognizes that IT will influence economic development extensively in the future. IT is a part of the government's national agenda and all policies are driven to achieve maximum benefit to the industry.

- The liberalization and deregulation initiatives taken by the Indian Government are aimed at supporting growth and integration with the global economy. The reforms have reduced licensing requirements and made foreign technology accessible. The reforms have also removed restrictions on investment and made the process of investment easier.
- The government is actively promoting FDI investments from NRIs (Non-Resident Indians) including Overseas Corporate Bodies (OCBs) owned by the NRIs. FDI can be brought in through the automatic route, based on powers accorded to the Reserve Bank of India.
- Till 1994, Department of Telecommunications (DoT) was the sole provider of basic telecom services in India. The new National Telecom Policy has opened up the field for private participants.
- After realizing the potential of India as a major IT power, the government has taken several initiatives to promote the development of IT. The Ministry of Information and Communication Technology is playing an active role in developing the infrastructure that supports the development of IT. The IT Bill passed in 2000 provides a legal framework for the recognition of electronic contracts, prevention of computer crimes, electronic filing of documents etc.

- Amendments have also been proposed in the Indian Evidence Act, Indian Penal Code and the RBI Act. The mechanism of digital signature has been proposed to address the issues of jurisdiction, authentication and origination.
- Recognizing the importance of Venture Capital Funding, the Ministry of Information Technology has set up a National Venture Fund for the Software and IT industry with a corpus of Rs. 100 cr in association with the Small Industries Development Bank of India (SIDBI) and Industrial Development Bank of India (IDBI). The aim of the Fund is to provide venture capital to start-up software professionals and IT units in the small-scale sector.
- The IPR law in India.
- National Association of Software and Service Companies (Nasscom) has been playing a crucial role in helping the IT industry achieve the ITS and ITES vision. Along with the government, Nasscom has taken many steps towards efficient implementation of the above mentioned government policies. Nasscom has helped the government implement almost all the original recommendations of the last Nasscom-McKinsey Report, concerning the capital markets, venture capitalists, Sebi and the Companies Act.

India's software exports contribute about 16% to the country's total exports and are the fastest growing segment

Entry of global IT vendors

Because of India's success in outsourcing, big global IT vendors have shown interest to set up their offshore development centers in India.

France-based Cap Gemini Ernst & Young, the world's fifth largest information technology services company has started a new development center in the suburbs of Mumbai that will house 250 engineers.

Major Indian outsourcing announcements have come fast recently: Multinational companies such as Accenture and EDS have set up software development centers in India. On the other hand, Microsoft and Oracle are also increasing their workforce in their Indian development centers. IBM opens a Linux research lab employing 500; Nortel Networks, which already has 1,300 developers in India, will spend $350 mn in the next three years and employ 500 additional research and development scientists; Cisco Systems will spend $200 mn on a development center; and Deutsche Bank is investing $4.3 mn to build a 50,000-square-feet development center that will eventually house 550 software professionals.

The effect

Their coming to India has both positive and negative effects on Indian software industry.

Cost Competitive Manpower: International Software Outsourcing Industry

Country	Number of Trained Professionals	Average Annual Wage	Total Software Exports
India	300,000*	$5,000-8,000*	$6 bn*
China	400,000; 35,000 hi-level professionals*	$6,000-8,000*	$1 bn*
Russia	3,000-4,000	$5,000-8,000	Unknown
Pakistan	23,000	$3,600-6,120+	$120 mn+
Philippines	30,000-50,000	$8,000-10,000	Unknown

Average annual wage is first-year salary for a highly trained professional.
* Nasscom Companies.
+ Software Association of Pakistan.
Other data is anecdotal information supplied by Marty McCaffrey, who refers to the data as 'rough orders of magnitude'.

"There are more positives than negatives for the industry," India's Nasscom has forecasted IT services and software exports to grow 30% in the year 2003, after managing 29% growth in the previous year. Software service exports totaled $7.5 bn last year, just missing the Nasscom's 30-35% target, while the US—making up 60% of demand for India's software exports—dipped into recession.

In fact, the downturn helped bring new clients to India's IT services sector. Budget squeezing retailers, and financial and insurance firms are taking over from grounded telecom clients in seeking cheaper outsourcing solutions.

India's software exports contribute about 16% to the country's total exports and are the fastest growing segment.

Niche skills in demand

But even as prospects improve, software giants Infosys Technologies and Satyam Computer Services are forecasting flat first-quarter sales and profit. After laying off workers last year, top Indian tech and IT services firms have resumed hiring.

But they aren't just hiring anyone. New jobs are going for candidates with niche skills and

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some experience. This is a far cry from the Internet boom years, when managers quipped, "Trespassers will be recruited."

Higher demand and proposals for large orders are brightening the prospects for the sector. "We are at a stage where prices might be stabilizing."

Average prices for software services offered from India have fallen by more than 5% to $20 to 25 per hour from last year, far below the $30 to 35 peak seen during the Internet boom.

The name of the game

Fund managers have cut exposure to the software sector after the growth rates sobered, but are still betting on a US recovery.

The game of investing in Indian technology is as simple as the game of Cricket, when the US economy picks up. "When you get a hard track, it is easier to hit a century."

Analysts say old economy and new economy valuations are leveling. They say shares of Infosys and Satyam are at about 26 and 15 times their respective estimated earnings for 2002-03 compared to price-to-earnings ratio estimates of 18 for the pharma company Ranbaxy and 28 for consumer goods giant Hindustan Lever in current calendar.

India's IT index, among India's worst performers in 2001, has risen 1 to 2% this year, compared to a 5 to 6% rise in the broader market.

Looming skills shortage

But India's software industry may face an acute shortage of more than half-a-million professionals by 2005, the country's top software lobby group said in a report.

The report released by the Nasscom, said the industry, which has spawned several Nasdaq-listed firms, would need more than 1.4 million computer programmers by 2005.

India's software industry may face an acute shortage of more than half-a-million professionals by 2005

"But the supply would only be 875,000," it said. According to the report, India's engineering colleges had not kept pace with an industry that has grown at an average 50% annually over the last five years. The industry has also lost many of its brightest young stars to the United States.

According to a UN report released in New Delhi in July last year, India loses US$2 bn a year in resources through the brain drain of 100,000 skilled computer professionals to the United States alone. The average total cost to India of educating each skilled professional was between $15,000 and $20,000, the report added.

The study also identified the southern Indian city of Bangalore as one of the 'world-class technological hubs' which has emerged to challenge Silicon Valley and other centers in Europe and Japan.

But a shortage of professionals may jeopardize India's attempt to grow to $50 bn by 2008 from $6.2 bn in the year to March 2001.

Competitiveness between Indian and MNC Firms

So long as the manpower working with MNCs and Indian companies are Indians, it doesn't matter really. However, in terms of business potential it does matter in drawing a distinction between MNC and Indian companies. The challenges are different for both MNCs and Indian companies. MNCs have an advantage as they primarily cater to the needs of other group companies and, hence, have a ready market. Also, the quality and credibility of their products are not questioned, as uniform standards are followed for their captive requirement.

The Indian subsidiaries of MNCs are cost competitive and, hence, the parent companies find it attractive to outsource their requirements from India. In addition, the Indian unit has also been identified as a global center for developing the project businesses of its parent.

For Indian companies, exploring overseas market is not that easy. They have to search and identify profitable markets and need to have logistics in place. This requires investments in marketing offices, personnel, and so on. Above all, they have to ensure product, services and solutions credibility before sale. The interesting fact is that the size of the company does impact its volume of operations.

The strategies

Offshore Solutions Providers from India need to bounce back in terms of their commercial attitude towards Offshore Software Development, in order to face the challenges posed by the multinational software and consulting firms, establishing their offshore base in India.

According to a McKinsey survey, 80% of the top 40 global IT services firms have their major presence in India. And with these multinationals heading towards success in their offshore outsourcing strategies focused in India, they pose a very big risk for the local offshore software developers in the long run. This is because even these multinationals can now offer the same cost advantages. As for example, Microsoft has one of its biggest software development centers in India after the US.

MNCs are growing their Indian operations by at least 40-50% every year. This includes software services companies such as IBM Global Services and Cognizant and spellbound offshore software development centers set up by companies such as HSBC, Standard Chartered, and P&O Ned Lloyd. Global players like Accenture, EDS,

besides others, are all rapidly adopting this model.

Some Facts: IBM Global Services India (IBM GSI) is aiming at adding 7,000 professionals over the next three years, in its six development centers across India. While bidding for a large project, Indian players often come across IBM GSI.

Cognizant had a gross addition of 993 professionals in the Indian center last year. This figure is expected to cross the 6000 mark in the very near future. Apart from these companies having their own offshore development centers in India, there are other players forming joint ventures with local companies in the same field to take the advantages of the huge market.

The tight spot for many clients who are looking at Indian players, is the lack of differentiation amongst the Indian companies. The Indian companies need to position themselves very specifically. And with so many companies coming up with the CMM and ISO level certifications, local companies need to find out a new USP to stay competitive and on top.

It is now feared that the 'cost-effective' offshore proposition has become a common denominator and the only differentiation left is the 'India-centric player' tag. Hence, Indian companies like Infosys and Wipro have also started investing heavily to ensure that the 'brand message' is communicated effectively. Wipro for example, has branded its offshore delivery mechanism as 'ShoreGain'.

The Indian players need to associate to cope with the upcoming competition

MNCs have come on top of competition in India with many of the strategic steps that are being seen as very important for the Indian companies to look at and come out with some more innovative strategies to stay competitive and lead the race. Outsourcing being the major focus at present for everyone, the Indian companies need to concentrate on what would be an outsourcer's vendor evaluation method, before outsourcing its work to anyone. These can help them target the exact requirements of the prospective clients and hence develop and maintain healthy business relations.

EDS: EDS made-up in outsourcing using IBM mainframes for Frito Lay. Initially, EDS worked with government clients (US Navy, US Federal Government) and automotive companies (General Motors). Then it acquired A. T. Kearney and others to move up the value chain and offer consulting services. The acquisitions also gave the company an entry into the private sector. It has made 10 acquisitions in the last three years.

Accenture: Communication and the high-tech areas formed a basic part of its strategic integration to jump in the competition. By regulating methodologies (Method One) and launching a network of alliances (SAP), it expanded into other verticals like utilities and energy. Deals on the lines of Accenture's acquisition of ITT's two divisions helped the company expand the scope of its service lines.

CSC: This Company has conducted over 20 acquisitions in last three years. In 2001, acquisition revenues were $2.8 bn (IT Services, Combitech and Mynd). It has also expanded geographically, BHP IT in Australia and KPMG in France.

Conglomerates: EDS, IBM Global Services and PwC are working together on a 10-year $3 bn deal for UK's social security system. This joint strategy can be adopted by leading Indian vendors to collectively bid for a large project. The Indian players need to come out with this kind of associations to cope with the upcoming competition.

Follow the leader

These biggies of the global software industry have posed a serious threat to the Indian players. But then again, where there's a will, there's a way. Instead of taking them as a threat, these MNCs can be followed in their footsteps of strategies or on the other hand the Indian companies can go forward for the joint ventures and collaborations in the market. Even some of these MNCs give the Indian players a big bunch of work if there's some kind of relationship between them in

Business Drivers for Global Players

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3. Global Operations
4. Global Resources
5. Global Collaboration
6. Introduction to Information Systems
7. Global IT Platform Issues
8. Global Systems Development
9. Local in Costs vs. Meeting Global Requirements
10. Multilingual Needs
11. Standardization of Data
12. Scheduling Global Activities
13. Global Infrastructure
14. Global Data Access
15. Transborder Data Flows
16. Global Computing Facilities
17. Hardware acquisitions
18. Software compatibility
19. Local Service
20. Balancing Workloads

business terms. Hence, the Indian players need to come up with innovative things as against these MNCs to compete them vis-à-vis being one of them in the competition.

The Indian software industry is currently undergoing a decisive phase in its advancement, and it would be a judicious step for the industry to learn its lessons from the Big Five. Acquisitions being the current trend, the industry needs to focus on the upcoming trends and act accordingly.

Outlook

Gartner's report mentions that during the current year India's revenues from offshore Business Process Outsourcing (BPO) would grow from US$1 bn to US$1.2 bn.

This will represent 66% of the global offshore market—where jobs are done outside the client's region.

"It will be supplemented by significant additional revenue from internal company operations and US firms setting up their own delivery centers out of India."

A lot of foreign firms such as airlines, credit card companies and banks have shifted their 'back-office' work to India which has the world's second largest pool of English-speaking computer literates after the United States.

Last year the BPO sector accounted for about one-fourth of India's total software export revenues of US$9.5 bn.

Demonstration of capabilities and deep knowledge of specific industries are the reasons for India to get lucrative outsourcing jobs.

Most of today's offshore BPO opportunity remains at the level of out-tasking a component of a business process and relegated mostly to contact centers and transaction processing.

India is clearly on a roll—but how long can it hold onto its crown? With the Nasscom predicting $50 bn software exports by 2008, some are starting to question whether India can maintain its competitive edge. Low-cost technology centers in China, the Philippines, Russia and Pakistan are sprouting up and competing for outsourcing projects, making it increasingly unlikely that India will reach that lofty-goal.

The offshore software outsourcing industry will no doubt continue its hyper-expansion in the next few years as Western firms look for cheap offshore talent to fill that gap, but it is clear that India could stumble and lose its crown.

India is likely to face troubles ramping up to the projected 2008 level. India would need to have 1 million qualified software engineers to support exports of $50 bn, and the country currently graduates around 110,000 computer science students a year.

Demonstration of capabilities and deep knowledge of specific industries are the reasons for India to get lucrative outsourcing jobs

With a dearth of experienced project leaders already on the horizon, that problem will reach a crisis point as outsourcing continues to expand at a rate of more than 50% a year. Additionally, many of India's best and brightest will continue migrating to the US.

When and if India does slip, there are plenty of low-wage countries that would be only too happy to pick up the slack.

Pakistan, for instance, has sought to emulate India's success by offering similar tax breaks for multinationals and is aggressively modeling its own educational programs in computer and information sciences on India's.

While China would seem to be the biggest threat, with 400,000 software professionals, only 35,000 of them are qualified to do the kind of high-level, systems-integration projects that are so coveted in India. Most of China's high-tech laborers are well qualified to work on software applications maintenance and migration projects, and these workers come at a significantly lower salary than do their Indian counterparts doing the same work.

The Chinese environment has traditionally been grounded in manufacturing and hardware, but that appears to be changing, and the Chinese Government has recently placed great emphasis on teaching English to students and IT workers, which is an extremely important skill requirement for American firms looking to outsource.

As a former British colony, India has already been extensively educated in that critical skill set, but perhaps not to the extent of the Philippines, a former American colony, where American culture and language are widely emulated. According to some analysts, those cultural and communications skills could prove to be so appealing to American firms that they would outweigh slightly higher labor costs in the Philippines.

As far as Russia is concerned, McCaffrey calls the situation there 'murky'. After the fall of the Soviet Union, there were more than 1 million registered engineers, but many of them have since retired, been out of work for long periods of time or don't have the necessary skill sets. Nevertheless, McCaffrey praised Russia's university programs in physics and mathematics and noted that the country has 'tremendous outsourcing potential' as an alternative to India. While top-notch talent falls into roughly the same price range, programmers can be found in areas outside Moscow for as low as $3,000 a year per programmer.

Those countries, along with a host of others such as Indonesia, Malaysia, Thailand and even Vietnam, will collectively challenge India's IT prowess in the next few years.

Reference # 1-2003-09-06

DISCOUNT RETAILING

Here to stay?

Wal-Mart has shown to the world the power of bargaining, and smaller, local players like Subhiksha are re-enforcing it. But, how far can discounting go?

Today is the age of 'discounting'. The global retail landscape is littered with success stories of companies adopting the discount store business model. No wonder that as consumers become more and more price-conscious in the wake of turbulent economic conditions characterized by high level of unemployment, discount retailers like Wal-Mart and Target are flourishing.

But then discount retailing is not just about low prices, as floundered giant, like Kmart, which was a pioneer in the sector, shows. To be successful with the discount retailing business model, retailers have to build robust brands so as to strengthen their negotiating position with the manufacturers. And, there are lessons to be learned from far and near. While Wal-Mart and Target have shown many a retailer, a working, extendable model, local retailers in India and other emerging countries also have made a mark on the discount retail arena by their uniqueness and innovation. Here is how?

The in and out

Discount retailing is a low-margin business characterized by heavy bargaining and negotiation with manufacturers. And, unless the retailers are good at it, they can't continue with discounted prices. How do you think Wal-Mart gives—"Always low prices. Always"? Through unparalleled negotiations with manufacturers.

The typical consumers are bargain hunters, the so called 'price-conscious' ones and as a result, for discount retailing the volumes more than make up the losses due to the discounted price. But just selling lower than others or at slim margins isn't enough to capture this new age consumer; he has to be lured by a robust branding strategy that optimally reflects the low-price promise. Wal-Mart, Kohl's have laboriously built brand names for themselves reflecting their commitment of offering low price merchandise. Only because of their strong brand association with low price, they lure customers. And because they attract a lot of customers, manufacturers give in to their negotiations. It is a complex game of relationships between various entities of the retailing value chain.

Discount retailing is a low-margin business characterized by heavy bargaining and negotiation with manufacturers

Over the century, retailing has undergone major shifts. In the US, for instance, from the so-called 'five and dime' stores opened some hundred years ago by Sebastian Spering Kresge in downtown Detroit to the supermarkets to the discounters, the sector has seen many a business model come and go. World over and not just in US, as Professor Mark Ritson of the Department of Marketing at London Business School says, "Discounting has grown with the power of the retailers who have steadily grabbed control from the manufacturers who used to run the relationship between the two."

The spread

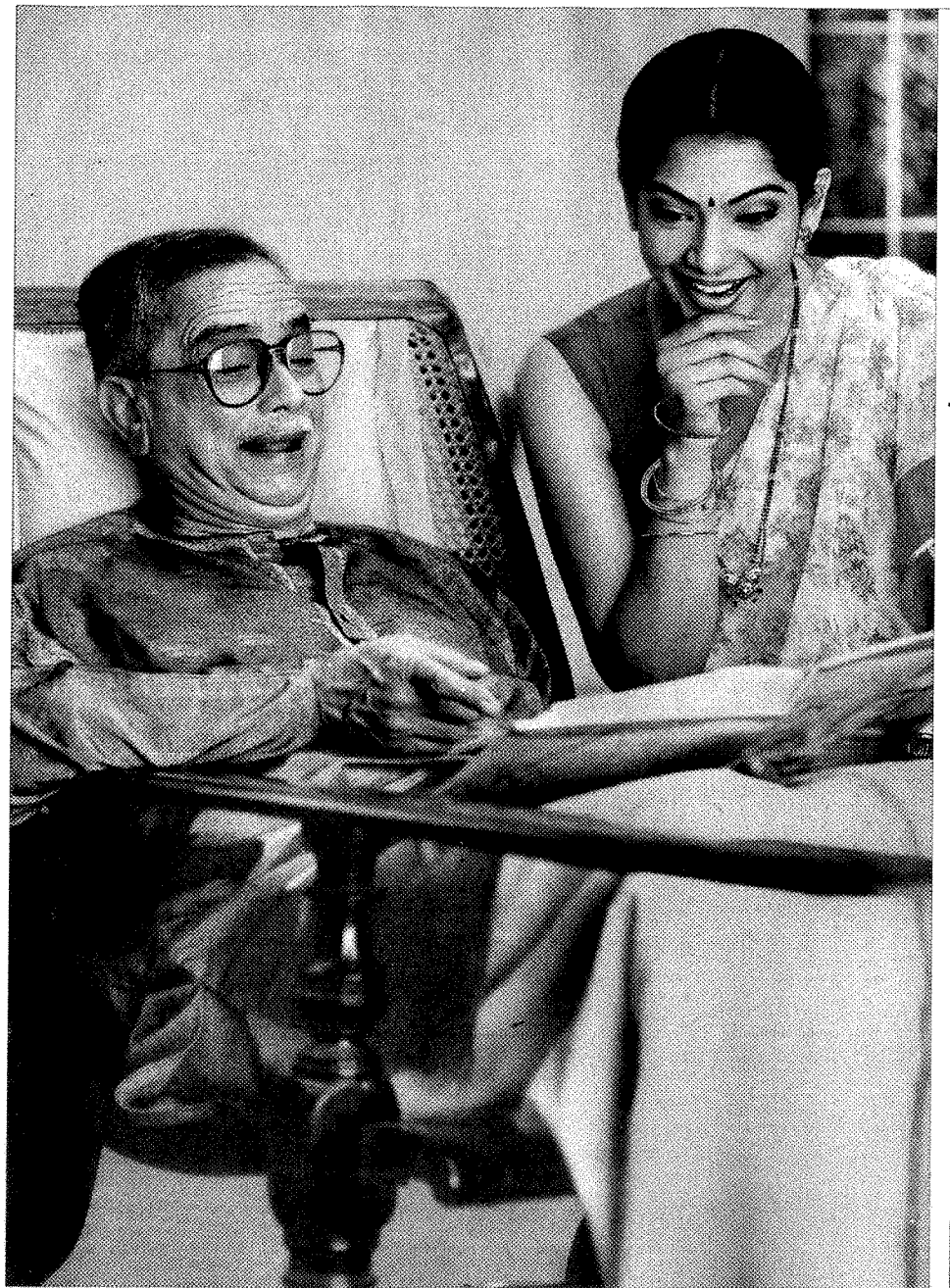
"Discount retailing has spread around the world very successfully. Lower labor costs, better sourcing and distribution, supply chain information improvements, and the combination of cyclical and counter-cyclical goods within the same store have contributed to great success," says Richard Hastings, Chief Retail Analyst at New York-based Bernard Sands.

Most of the leading retailers of the world have been expanding overseas, with US retailers at the forefront, followed closely by European giants. Aldi and Lidl, for instance, have successfully exported their hard discount expertise to about 16 countries.

Over time, the concept has evolved into various forms also: All-purpose (like Wal-Mart) and specialty discount stores (like Circuit City, Best Buy). Then there are hard discounters and soft discounters, named so because of the kind of merchandise they stock (hard goods and soft goods respectively).

While US is the most diverse of the markets, offering opportunities for all kinds of discounters, the European market is equally diverse—Germany is the home of the hard discount whereas the Nordic countries are more skewed towards soft discounting.

Reflecting a broad trend, the discount retailers are profiting globally. The 'No-Frills' approach, which has a parallel in Airlines industry, has been generating revenues for the companies adopting it. But like in the airlines industry, where not all are Southwest, in this sector, not all are Wal-Marts or Targets. Because discount retailing is a tricky business, not all companies which offer low prices succeed, as the pioneer, Kmart's case shows.



How often does a daughter break a father's heart? About a million times in one day. The day she leaves home. And how did I cope? By making that day the happiest of her life. Saving for it for years. In a special deposit, just for her. KVB's Thirumagal Thirumana Thittam. It helped get her the right husband, the right jewellery, the right saree. She's radiant. I'm grateful. That someone understands the importance of this day. It's my bank.

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The Kmart story

The Kresge store (which evolved into Kmart later) appealed to many because of quality merchandise at low prices. The store sold all merchandise for 5 and 10 cents at times when America was distressed with war and financial depression that resulted in unemployment (much like today's situation).

Over the years, the company continued with its philosophy of affordability and by the mid-1920s it opened up stores that offered goods at $1 or less, next to the traditional Kresge 'five and dime' stores. These stores could be termed as the precursors of discount stores. The first Kmart stores made their appearance in 1962 around which time Wal-Mart made its appearance in Arkansas, thus starting the discount revolution. As the 'discount' stores became popular, Kresge Company sold the Kresge stores by 1987, to entirely focus on discount merchandising.

Despite being a pioneer in this niche-retailing sector, Kmart couldn't withstand the competition from Wal-Mart, Target, Costco, Kohl's and the like—all of which had mastered the art of discount retailing. All of them are tough negotiators and good supplier managers. They are experts in controlling costs and well known for being tech-savvy. While its competitors lured customers away from it through customer-friendliness and efficiency, Kmart was ruined due to its shoddy management of suppliers and store space, and shoddier customer service.

The discount retailing business rests on the pillars of promise and delivery of low price. In order to keep these pillars strong, the company has to build a healthy brand and manage resources, especially financial ones, in a prudent way. It's a cycle—price-conscious customers buy from discounters, as more and more customers become price-sensitive, discount retailers increase, and as discount retailing booms, margins and price become lower till they reach saturation, then people will expect much lower prices and some innovator will give them deeper discounts and then the cycle starts again.

The emerging market players

Even as the giants in the sector having huge financial as well as bargaining muscle are making inroads into the emerging economies by exporting their retailing formulae, the smaller, local players have created a niche of their own.

From the discounters like The Yansha outlets of China, to the hypermarkets and massive discount supermarkets of Thailand, to the super bazaars of India like Apna Bazar, Subhiksha and the like, all have expanded and leveraged the concept to its full extent.

The discount retailing business rests on the pillars of promise and delivery of low price

In India, we have the supermarkets (Foodworld, Nilgiris) and the discounters (Apna Bazar, Subhiksha) and increasingly discounters are finding favor with the typical consumer, more so in South India, which has seen a spur of activity in the sector. The most well-known discounter in the south, Subhiksha is a supermarket and a pharmacy chain. Subhiksha zeroed in on the discount retail format after a survey that revealed that customers were price-sensitive and price drove the decision along with accessibility, availability and quality of merchandise. The study also revealed that customers weren't ready to pay more for shopping in an AC store. Moreover, Subhiksha thought that discount stores are the ideal way to cater to the cost-conscious customers and to compete with the kirana stores. Today, it has about 52 stores in Chennai with impressive annual turnovers. Saravana, which became well-known because of its bargaining prowess with Marico, has a strong hold in the Southern markets.

In Kerala, Margin Free, a cooperative discount store, has aggressively captured a handsome share of the market.

The trend has caught on well worldwide. Therefore, as more and more small players crop up and more and more global giants adopt the model, there will be a consolidation spree in this sector of the retailing industry. "As retailers consolidate their power continues to grow. With consolidation comes globalization. These two trends mean we are likely to see more and more discounting in the future," says Prof. Ritson.

The winners

With consolidation and globalization, only the big and the nimble innovators will survive. Those who get mired in inventory, pricing and cost-related problems will perish while those having a strong brand, bargaining power and cost efficiency will succeed. As Richard Hastings says, "The winners, in the US, will be Wal-Mart, Target Stores, Costco, Walgreen, CVS, and the dollar stores including Dollar General, Family Dollar, and the closeout retail chain Big Lots."

But then there is a limit to cost-cutting, lowering prices and negotiating margins. And also, there is every chance of discount retailing evolving into something very different, giving way to wholesale clubs in US, or the kirana stores in India.

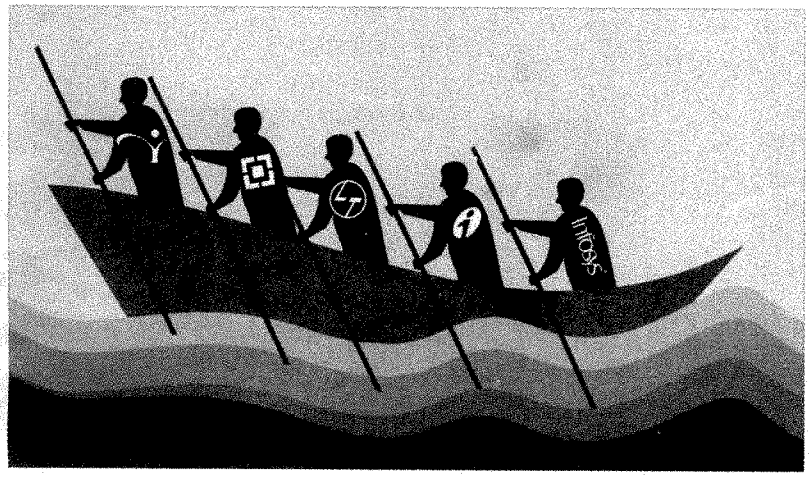
C S V Ratna

Reference # 1-2003-09-07

BSE SENSEX

Going the free float way

The BSE Sensex is shedding the market capitalization measure and embracing the free float methodology. What would be the impact of this transformation?



Come September 1 this year the BSE sensex would use the free float methodology to determine the relative weights of its constituent companies. Free float is that portion of the shares that is actively floating and is available to the investors for buying and selling. The free float excludes shares which are blocked and not actively traded like the promoters' stake, government shares, strategic holder shares and other locked in shares. Free float is the measure of the liquidity of shares of a company from the investors' point of view.

The BSE sensex till now was using full market capitalization methodology for determining the weights of the companies in its indices. The market capitalization methodology has its own problems. A company with a large market capitalization but very less free float might have a greater weightage in the index which uses market capitalization methodology. When passive fund managers pursue companies with such high weights, the price of these companies is bound to rise because the available shares are very less. This rise in price is not due to the intrinsic competencies of the company but due to the demand and supply mismatch. On the other hand, weights determined on the free float methodology of index construction would not have the same problem. The free float methodology is considered to be the best practice and all the major index providers like MSCI, FTSE, S&P and STOXX have adopted the free float methodology.

The free float methodology gives the flexibility to include any stock in the index from the universe no matter how large the company is in terms of market capitalization (even though the free float may be small). It also facilitates creating a quality portfolio with improved sector and market coverage. There cannot be any undue influence of any closely held large-capitalization stock on the index movements.

The winners and the losers

When the sensex moves to free float the companies, which had high market capitalization, but less free float like PSUs and MNCs would see their weights decrease. PSUs have a large portion, which is held by the government, and these shares are not traded in the market. The MNCs have a large portion of shares which is held by the foreign promoters which is again not traded. On the other hand, companies with more free float would see their weights increase. So the free float methodology of index construction rewards companies, which have a large number of shares floating in the market. Companies with a higher promoter stake like Reliance Industries, HLL, SBI, MTNL, Nestlé India, Hero Honda, Zee Telefilms, BSES, Glaxo, HCL Technologies, Colgate Palmolive and Castrol would be the losers while ACC, Gujarat Ambuja, Infosys, ITC, Ranbaxy, HDFC, ICICI Bank, Dr. Reddy's, L&T, Hindalco, TISCO, Satyam, Bajaj, Grasim and Cipla would be the winners. The major loser is HLL, which will see its weights drop by 2.58%. The major gainer is Infosys, which would gain by 1.68%.

Now coming to the question as to whether this would encourage the government to disinvest, the answer is very easy. The disinvestments are guided by many other major factors like timing, pricing etc. Hitesh Porwal, Head, Index Cell, BSE India, also agrees. He says, "I don't think the new methodology would have any direct impact on the divestment process. However, the free float methodology does encourage larger participation by investors in a company. Any PSU in index would see a rise in its weightage (other things remaining the same) once its equity is divested. But, again

passive investing in India is not significant to have such a major impact."

The companies' relative weights will be adjusted by their free float adjustment factor. BSE has already announced the companies with their respective free float adjustment factor. But this might lead to a problem. A company which has a constant changing free float might see its weights moving up and down. To prevent such problems BSE has come up with a banding structure that reduces the potential of frequent changes in the free float factors of index companies. For e.g., if a company is having a 15% free float portion out of the total capital it will come in the range of 10-20% and will be assigned 0.2 free float adjustment factor. So, unless there is a substantial change in free float it would not make any difference in the weights.

Realign to be in line

For active fund managers this free float methodology will act as a better evaluation technique because sensex will be a better benchmark, with less tracking error. But the passive fund managers i.e., the index fund managers and Exchange Traded Fund managers will have to realign their portfolio in line with the changed sensex weights. However, this activity is not going to affect the share prices of individual companies because of the following reasons:

- Only around Rs. 370 cr is invested in passive funds tracking the sensex. This amount is very less compared to developed markets so the effect will be insignificant.
- The similar shareholding pattern of Indian companies can be the other reason. The free float market capitalization of most of the companies has reduced proportionately, thereby making a very little impact on their relative weighting in sensex. The percentage change is based on the sensex data of July 21, 2003. The exact percentages would be known only on August 31, 2003, the day before the shift to free float methodology.
- A six-week advance notice has been given to the fund managers before the actual shift. This provides enough time to the index fund managers to plan out their portfolio rebalancing. International experience shows that the portfolio rebalancing is not undertaken on the last day but tactfully planned over a period of time before the last day. The same is expected in India, and since the amount of money indexed is small the impact on prices of individual companies will be insignificant.

FIIs will take free float methodology very positively because it brings sensex on par with the best global practices

Future plans

Will this new methodology change the sensex value? This question might arise in the minds of some retail investors. But the answer is No. There will be no change in the sensex value due to change in this methodology. The sensex will continue to reflect the market position in the same manner as it was showing earlier. Only the relative weights of the sensex constituents will change. Indeed, the weightage of top 10 scrips will have a very minor effect.

The BSE sensex is also going to be reconstituted after the free float methodology stabilizes. Some of the stocks would be removed from the index and some added. The likely candidates are—Maruti, Punjab National Bank, ONGC and Wipro. TCS that can be the strong candidate for inclusion in the index will only be included, if listed at the end of this year. All these companies which will make their entry but with less influence on the index as their free float factors are low. So, there will not be any effect of sharp rise in prices of these stocks.

> **"I don't think the new methodology would have any direct impact on the divestment process."**
>
> **Hitesh Porwal**
> *Head*
> *Index Cell*
> *BSE India*

Welcome move

The move towards free float methodology is significant as it conforms global best practices. FIIs will take this move very positively because it brings sensex on par with the best global practices in index construction. Porwal says, "FIIs generally benchmark their portfolio and performance to a free float index and thus would find a ready benchmark in the form of sensex for the Indian markets." Fund managers, too, will find the free float methodology better as this methodology will better reflect the market movements in the form of stock prices or returns. The movement in the index will be lower if weighted by free float instead of market cap. The funds that are benchmarked to BSE sensex will be better off because the tracking error will be lower.

Phulvinder Kaur

Reference # 1-2003-09-08

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DISINVESTMENT

Revival of interest?

The success of Maruti IPO has opened up new ways for the government to accelerate its disinvestment process. However, the disinvestment commission should be cautious about the future disinvestment proposals.

"The disinvestments target for this fiscal is Rs... cr." This is the common statement that finds place in the budget proposals of the Indian Finance Minister ever since the government mooted the proposal to disinvest its stake in the various public sector undertakings. Though the statement is made in every annual budget, the targets are never met. For the last four to five years, the government has been pursuing disinvestments as a strategy to reduce its fiscal deficits without much success.

Though on many occasions, the target seemed to be achievable, the government under the Disinvestment Commission could never report that the targets were achieved. While various factors contributed to the poor performance of the government on the disinvestments front, the success of Maruti Udyog Limited's (MUL) IPO recently, hints at the possibility of achieving the targets for the current fiscal. Can the targets be achieved this time? Does the success of MUL's IPO offer a new route for disinvestments? What are the roadblocks still present in the disinvestments process? These are only a few questions that policy makers and market players are pondering on.

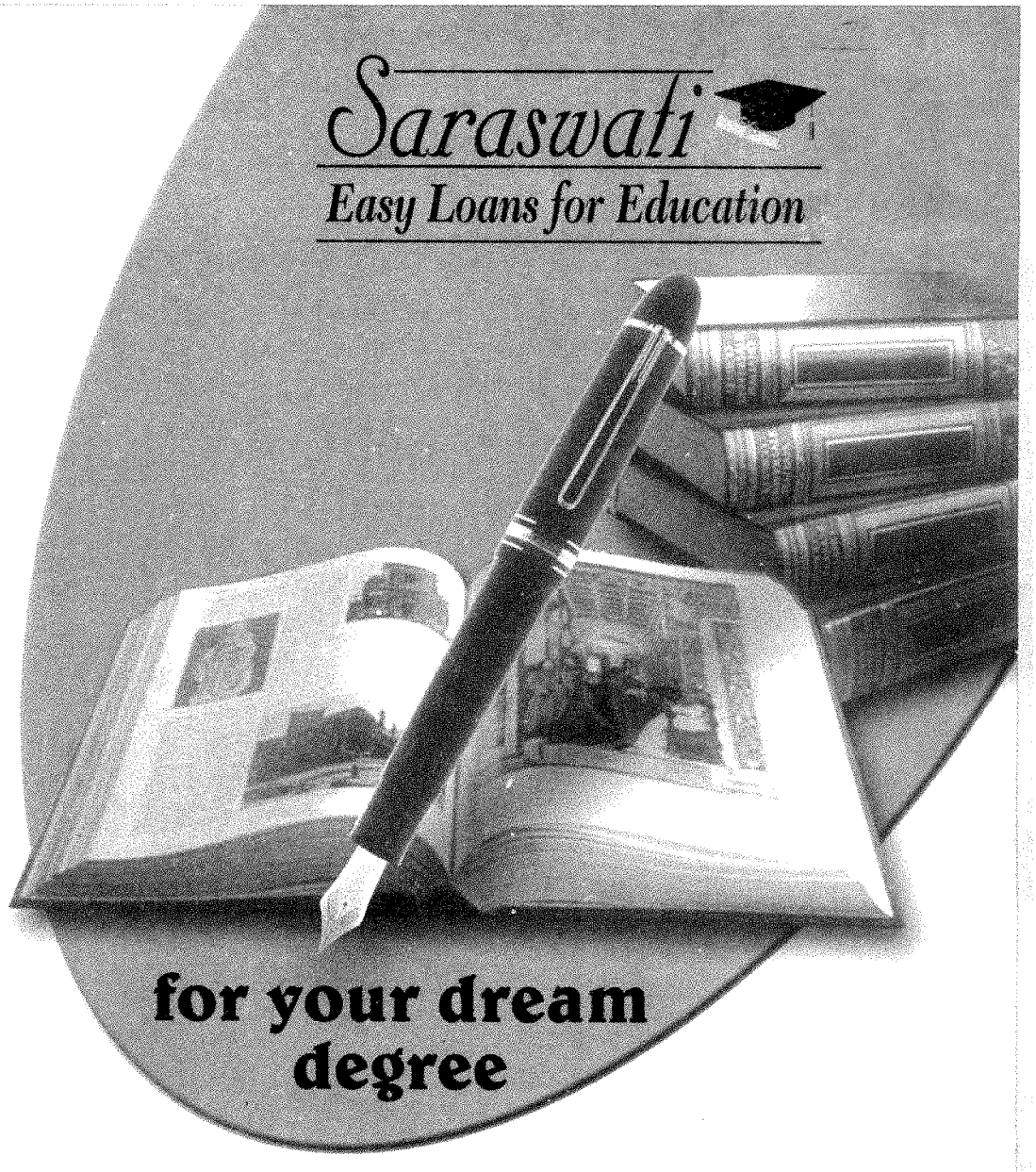
Backing on MUL's success

Perhaps no one would have known that MUL's IPO would be such a big success and act as a booster for the rest of the disinvestments process. Immediately after the success, the Disinvestments Minister Arun Shourie indicated that the Cabinet Committee on Disinvestment had cleared the disinvestments of government stake in another five PSUs through the market route. This indicates the increasing confidence of the government to tap the primary markets for further disinvestments. But does the success of MUL reflect the growing interests of investors in privatization or is there any other reason?

Arun Jethmalani, CEO, Valuenotes (an independent research firm www.valuenotes.com), feels, "The success of MUL will lead to a revival of interest in disinvestments. However, the government should realize that the Maruti case is an indication that there is sufficient demand for decent quality and high liquidity paper." In fact, what he feels is that the success of future disinvestments through the market route can only be assured if the quality of the companies is as perfect as MUL. Echoing a similar viewpoint, B G Mahesh, CEO, Indiainfo.com, says, "Maruti IPO is a classic public issue. The issue was very successful on account of the strength of the company, its brand, timing of the IPO and the issue price."

Though the future disinvestments may not witness similar success, the government is now confident about the achievement of the target. Government should take a cue from the success. For the first time, the government has tried disinvestments through the market route. Earlier, it was the strategic disinvestments route, where the government/disinvestments commission had to face the challenges posed by various political parties, labor unions and other parties. At the same time, the government was dependent on the response from select few leading corporates. Dr. V V L N Sastry, Country Head, Firstcall India Equity Advisors Pvt. Ltd., in the article ('Maruti IPO's Success' published in the August 2003 issue of *Analyst*) has pointed out that "Since the corporates are using leveraged buyout mechanism for the acquisition of PSUs, not much fresh flow of capital is emerging from the disinvestments. Now that Maruti has shown the road map, in terms of wider investors' participation, definitely, government should exercise various possible options for disinvestments process. It is not a bad idea to float a normal IPO and have the participation of the public completely in the disinvestments process." In fact, this is the appropriate time for the government to accelerate its disinvestments program through the market route as the investors have begun to perceive the PSU investment as a safe haven.

Commenting on the government's initiative and investor interests, Arun says, "The government is likely to accelerate its disinvestments program. However, most other companies will remain in government control (unlike Maruti), so there may not be the same level of investor interest." Though broadly in confirmation with the above statement of Arun, Mahesh feels, "It was a shot in the arms of the Disinvestments Minister, and as per the budget commitment the government was able to achieve some breakthrough due to continued Bull Run. However, the attraction for the future disinvestments will depend on the



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Future

It is always better to make hay when the sun shines. The government is also trying to capitalize on the feel good factor established in the primary markets for the PSUs. Suddenly there is a change in the perception of the Disinvestments Ministry and the government who are eyeing IPO route for further disinvestments. Government intends to liquidate its stake in VSNL, Balco, IPCL, CMC and IBP through the primary market route in the next six months time. This is not only going to boost the disinvestment proceeds of the government but also the primary markets as they are going to witness a lot of activity in the coming future.

While there are a lot of optimistic views about the future disinvestments activity and success, there are still some issues that the government should address before finally putting things on a fast track. Earlier, it was political intervention that delayed or halted the disinvestments process in case of certain companies. However, since the government is now willing to offer its stake to the public rather than to corporates, the level of political intervention in the process is minimized. However, there are concerns about the government's willingness as the general elections are round the corner. In case the disinvestments commission acts independently of the ruling party's political wills, the process may be smooth. Otherwise, the prospects of cashing on good market sentiment will be lost.

> **For disinvestment to succeed, change of management is crucial. Investors will pay more if management control is not with the government.**
>
> **Arun Jethmalani**
>
> *CEO, Valuenotes*
> *(an independent research firm www.valuenotes.com)*

Arun extends a word of caution in the new found route, when he says, "Going by the past indications, there is every likelihood that the government will get greedy in pricing. If disinvestments by IPO is to succeed, there must always be a margin for immediate appreciation for the investors, which will whet their appetite for future issues." He further adds, "In addition, larger amounts should be reserved for 'small' investors, as institutional demand will help sustain secondary market prices post-listing." The government should be cautious about the pricing of the issue, as this is one factor that is going to determine the success of the issue or disinvestments.

Another important factor that will probably determine the success of disinvestment via primary markets is timing of the issue. Mahesh opines, "The government should tackle and handle the timing of disinvestment. If the Bull Run is for bank shares, governments should think about disinvestment in banks and not in steel sector." In fact, if the government follows this logic, the probability of success will be high.

There is a definite change in perception about disinvestment both in the mindset of the government and the general public. Supporting the government's thrust on disinvestment, Mahesh says, "Government should continue to proceed in the direction of disinvestment, in all non-security risk industries (defense, space, aeronautical etc.). It is no longer the government's business to run steel, coal and other product-related businesses. It is high time that the government concentrates on policy framing after taking necessary feedback from various industrial forums." Commenting on the future prospects of disinvestment through the market route, Arun says, "For disinvestment to succeed, change of management is crucial. Investors will pay more if management control is not with the government. A possible solution is to combine strategic sale with IPOs to the public."

> **The government should tackle and handle the timing of disinvestment. If the Bull Run is for bank shares, governments should think about disinvestment in banks and not in steel sector.**
>
> **B G Mahesh**
>
> *CEO, Indiainfo.com*

While the efforts of the government to go ahead with the disinvestment process are laudable, it should be careful in selecting the companies and the route. It should use its discretion and decide which route to adopt for which company. At the same time, the government should also ensure that the disinvestment process is not unduly delayed and the investors lose interest. With the revival of interest in disinvestment, thanks to the Maruti IPO, the day may not be far off when the Finance Minister will finally report that the disinvestment targets are achieved.

Y Chandra Sekhar

Reference # 1-2003-09-09

Stock Options: End of the Honeymoon?

Stock options were hailed as the key to infinite wealth. Employees turned millionaires overnight by cashing on their stock options. They also inspired entrepreneurs who used them to lure employees. In 1999, Seattle local employees alone made $8 bn on options. However, the era of gold rush about stock options has ended. Currently, more than half of the outstanding stock options are worthless because the stock has fallen below the price at which they were fixed. Some of the employees have ended up in bankruptcy after borrowing against their options. Moreover, there is a growing controversy as to how to account for the cost of awarding stock options, with regulators and investors seeking to have companies count option grants as an expense. Besides, Microsoft's recent decision to give workers grants of stock with guaranteed value instead of more speculative stock options is forcing many companies to rethink on how they use options to recruit and retain employees. As the world's biggest software company, it set a certain standard as far as the tech labor market is concerned. Since stock options act as a tool to retain and motivate employees, how will this move affect employees, investors and the tech industry in particular?

Over the years, many tech companies have been fighting the increasing political pressure to count stock options as an expense on company reports, which was long opposed by many Silicon Valley companies. Experts opine that Microsoft's move could stimulate to rethink on stock options as a preferred method to reward employees. They believe that Microsoft's move is the end of options as a way of spreading wealth.

On the other hand, granting stocks to workers rather than share options will give a clear picture of the company's financial position, because stocks are recorded on balance sheets. The software major argues that shares are a better incentive than options, since they are always worth something; options, by contrast, can quickly become worthless if the company's share price falls more than expected. For long there has been disagreement among companies and pay consultants over which form of compensation works best. Pay consultants say that tying pay to company performance in some way is crucial, but there are concerns that a focus on short-term share-price movements might detract from the long-term interests of the company.

With the latest move, experts say that Microsoft will now be a benchmark of real earnings. On the earnings front, technology companies are always under controversy, whose reported profits would be far lower or negative if they were forced to account for their options grants as compensation costs. What are the other popular rewarding tools to retain employees? What are the factors that contribute to Microsoft's sudden decision to ban stock options? Are corporate scandals being fueled by stock options? Are stock options popular because they are not counted as expenses? To debate on these issues *Analyst* invited Bruce Brumberg, Editor-in-Chief, www.myStockOptions.com, Corey Rosen, Executive Director, National Center for Employee Ownership, Daniel P Moynihan, Principal, Compensation Resources, Inc. and Rick White, Chairman, The International Employee Stock Options Coalition (IESOC) and Chief Executive Officer, TechNet.

N Janardhan Rao

Bruce Brumberg
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Microsoft's shift to restricted stock highlights a trend that began accelerating at the beginning of 2001 when it became clear that the bull market was over. Microsoft's decision is unique to it and its situation. Its decision has made more companies to seriously focus on alternatives to stock options as the prime form of stock compensation. What is most interesting about the decision is the plan to let employees sell underwater options to JP Morgan (assuming it gets approved). This could have even bigger implications for stock options and create new business opportunities for financial institutions, banks, and securities firms.

Stock compensation is here to say. It's too powerful an incentive tool and wealth builder in up-markets. It has become deeply engrained in the ownership culture and pay at many companies. The form of it may shift and be more varied at companies (and within companies).

Microsoft's decision of not banning stock options is just shifting the form of stock compensation and still keeping its stock plan broad-based for all workers. Microsoft wants to customize its stock compensation, so that options are not the form used because it feels restricted stock units and performance share have more power to recruit, retain, and motivate workers. It is also hanging its dividend and accounting policies, so these contributed to its decision. This situation does not fit every company.

Should the stock market continue on its current bull run, you might even see Microsoft return to selected stock option grants. Compared to restricted stocks, options have much more wealth-building potential and leverage for employees and executives. Microsoft may find that should the job market get competitive again for tech workers, it needs to return to granting options because competitors are doing it.

Stock options are not the main fuel of the recent corporate scandals. Stock options, along with about dozen other factors (ranging from lax financial analyst, regulators, and media, to overzealous individual investors), played a small contributing role. Changes in stock options and accounting have been wrongly held up as a 'false' god that somehow will end financial scandals.

Compared to restricted stocks, options have much more wealth-building potential and leverage for employees and executives

Accounting rules played a contributing role, along with many other factors, such as cheerleading boards and our general love of 'all things stock' in the late 1990s. However, even if there were no such concept as 'stock options', when companies are profitable and cash-rich, they find ways to pay senior executives very well. Stock option accounting is the wrong focus. It's hard to value options, they are a non-cash charge, and financial statements can get more confusing to compare.

What we have seen on myStockOptions.com, with our educational content and tools, is that stock options and equity compensation are important wealth builders and motivators for middle class workers who will never get the salary and cash bonuses they deserve. Disappointedly, changes in stock option accounting and other shifts in stock pay may hurt middle class workers and small entrepreneurial companies, much more than the top executives.

Corey Rosen
Executive Director
National Center for Employee Ownership
California
crosen@nceo.org

Microsoft is an industry leader, so its decision will certainly affect the thinking of other companies. However, in the first few weeks after they made their announcement, only a handful of companies have followed their lead. On its own, I do not think the Microsoft decision will make a huge difference.

The most important aspect of the Microsoft announcement is what it did not announce: It did not say that it was going to cut back on the concept of sharing equity with all its employees. This remains the core commitment; only the form of the commitment changes. Microsoft is providing Restricted Stock Units. This means employees will get shares of stock after they have worked enough years to vest. Unlike restricted stock, they will not get dividends on shares granted to them before those shares vest. They will get fewer shares of restricted stock than stock options. Restricted stock has value even if the shares go down, so a smaller grant upfront has an equivalent value to a larger grant of options. That means, of course, that in a company with rapidly rising stock values, options are better.

In more stable companies, or those with stock values that decline, restricted stock is better. Other equity plans include stock

How to Make Stock Options Work Better and Prevent Abuses

Our financial markets on their own have helped us win a few battles against perceived stock option problems. But we are going to lose the war unless we stop our fixation on stock option accounting and address head-on what really bothers us.

Thank You, Enron

Enron serves as a powerful warning for investors about the need to diversify. It's an equally strong symbol for the compensation committees of boards, and for the professionals who design equity compensation plans, that the era of 'good feelings' about stock options has ended. Arguably, boards now have a fiduciary duty to more closely scrutinize future stock option grants and justify 'super sizing' with more than the standard proxy statement cookie-cutter language.

Whether or not you believe stock options played the leading or supporting role in the unrelenting stories of corporate scandals, their association with this wrongdoing has tarnished them. Plus, the current bear market is naturally causing compensation packages to partially shift away from stock options.

It would be disappointing if the troubles with past grants to senior executives and the market slump discouraged companies from continuing to expand the use of options as an important long-term benefit for lower-level managers and key employees. Option grants (and employee stock purchase plans) for these workers make a much more positive impact on their lives than just piling on more grants to already very highly paid senior executives. I regularly hear on myStockOptions.com from middle class workers who plan to use option proceeds to finance a down-payment on a house (first ones, not tax-shelter mansions in Florida!) or fund other personal and family goals.

Jolt from Coke

Market forces and institutional investors, not mandates from the Financial Accounting Standards Board (FASB) or new laws from Congress, have led Coca-Cola Co., Bank One Corp., Washington Post Co., and other companies to expense stock option costs on their income statements beyond the detailed footnote reporting.

Based on my discussions with staff in the finance and HR departments at major companies, the announcement by Coke is prompting all public companies to take a much more serious look at whether they should voluntarily expense options or provide extra disclosures. The new summer fad in our executive suites is running the numbers (not the jogging track) on expensing stock options.

The Real Enemy Goes Free

As someone who has spent most of his career writing about and analyzing the technical issues involved in equity compensation and securities disclosure, I'm amazed and amused with how an accounting rule has become front-page news and the cause célèbre for the most respected financial journalists in our country. The problem is that the fight for changing the accounting rule removes the spotlight from what really disgusts us: Senior executives who profit from fleeting and false financial results.

We naturally want to hang a few accounting rules after all these scandals. But before we string this one up we'd better understand that the change would do nothing to prevent the identical stock option abuses from recurring. I'm concerned that we're worshipping a false god in our quest for easy solutions.

The Prescription

Let me introduce a few ideas that could serve as a compromise in this never ending debate:

- **Accounting Rules:** Expense options granted to a public-company executive when they exceed $1 mn (or some other amount based on grant date value) in any 12-month period, unless the options have index or premium exercise price, performance vesting, or similar performance-oriented provisions. This means that the options are valuable only when the market price of the company's stock exceeds those of competitors (and not merely rises along with the general market) or when the company reaches certain financial benchmarks.
- **Tax Code:** Companies currently cannot take a tax deduction for compensation over $1 mn to any executive, unless it's performance-based. Most options are 'performance' pay exempt from this cap. Instead, for options and restricted stock to be considered performance-based, require them to have index exercise price or premium vesting provisions.
- **Securities Regulations:** Return to some form of the rule that existed before 1991 that forced executives to hold their stock for six months after exercise. Should they sell the stock prematurely, they had to give any trading profit to the company.

Let's adopt some targeted reforms so that in the next bull market our senior executives really earn their option profits!

By Bruce Brumberg
Editor-in-Chief, www.myStockOptions.com

appreciation rights, phantom stock, employee stock ownership plans (a kind of plan specific to US tax law with many tax benefits), performance shares, and employee stock purchase plans (a discounted stock purchase arrangement).

The impending change in accounting rules means that all forms of equity compensation will be on the same level, so Microsoft just was one of the first to decide that since there was no longer an artificial inducement for stock options as a form of equity compensation (compared to other plans), it could go ahead and pick a plan better suited to its current circumstances as a mature tech company.

Corporate scandals of the past few years were fueled by stock options but there is an important

distinction here. They were fueled by outrageously large grants of options to executives, not by broad grants of options to employees. This latter practice has been shown to improve corporate performance; the former harms it. It is not options per se that are the problem; it is who gets them and how much they get. Smaller, more performance-based grants to executives and broader grants to employees are an effective combination.

Stock options were so popular because they are not counted as expenses, but this does not mean that equity compensation will go away; only its form will change.

Daniel P Moynihan

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My opinion is that the Microsoft decision will not greatly impact the tech industry over time. There may be a short-term abbreviation in the granting of options, but for the long haul they will remain a vital tool. The reality is that there are many factors at play including International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) actions to expense options, that must be understood before a final decision on options vs. restricted stock can be made. Technology companies are fueled by innovation and enthusiasm, as well as the hope of financial gain. Privately held companies will continue to use options because they cannot afford to do otherwise. Large publics will have more pressure on them as a result of the Microsoft decision. In non-tech firms, the decision has had a ripple effect. There are those who will follow suit—*a la* DaimlerChrysler, but most are taking a wait and see approach.

The Microsoft's decision is good for employees at Microsoft. They are getting Restricted Stock Units that will convert to restricted stock, and will be exercisable for cash regardless of the price of the stock (unless it is $0—which is highly unlikely). Typically, restricted stockholders have the right to receive dividends or equivalents, and this is good. But in the Microsoft case, they will not be eligible to receive dividends on their units, which could pose a problem if Microsoft gives out a large dividend payment, as has been rumored in the press. Also, since they are units, the holders cannot file an 83(b) election with the IRS which could minimize their tax exposure greatly over time. So, on the surface they sound good, but they are not perfect. Employees are motivated by many things. Titles, recognition, ability to contribute, and money, as well as a host of other things. The key to retention of key employees is to find what makes them tick, and create programs that are flexible enough to hit the mark with those who you really want to retain.

Companies will continue to make choices about stock option plans that best serve their shareholders and employees

Microsoft's sudden decision to ban stock options is fueled by accounting changes, shareholder concerns, public outcry, and the desire to put a positive spin on this area, and not to get bogged down.

I do not agree the notion that corporate scandals of the past few years were fueled by stock options. These scandals were fueled by greed. Now, those greedy few have created a situation where the government has stepped in, and made it much more difficult to do business for the rest of the world. Sarbanes-Oxley is great in theory, but is giving many companies financial aggravation in an effort to comply.

Stock options were so popular because they were not counted as expenses. During the Internet bubble, the start-up tech companies did not have enough cash to compensate the key talent, and used options as a future promise to pay. The lack of expensing is definitely a plus when evaluating what tools to use. Cash gets expenses, restricted stock gets expenses, options do not. The decisions were easy.

Rick White

Chairman, The International Employee Stock Options Coalition (IESOC) and Chief Executive Officer, TechNet

Three central goals inform our stand against mandatory expensing of stock options:

- A commitment to broad-based stock option plans as a tool for innovation and for attracting talented workers,
- A belief that rank-and-file workers should benefit from broad-based plans, and
- A desire for more accurate and transparent accounting.

Companies will continue to make choices about stock option plans that best serve their shareholders and their employees, so Microsoft's decision should not dramatically affect the technology community one way or other.

Microsoft's decision was a voluntary choice made by a mature technology company that, through its grants of restricted stock, reinforced its commitment to broad-based employee ownership. The company's announcement proves the wisdom of the current FASB rule, which allows companies to

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Microsoft Replaces Options with Restricted Stocks

On July 8, Microsoft announced that it would replace its stock option grants with restricted stock. The company would continue to give stock awards to most employees; only the form of the award would change. The stock would be time vested for most employees but performance vested for the top 600. Much of the restricted stock for executives would be performance vested. Microsoft also announced that it would now take a charge against earnings for its stock options as well as its future grants of restricted stock (the latter is required under current accounting rules; the former is not). The company will account for prior grants as well as current options. The change come as a result of employee concerns that their options had not done very well over the last few years; restricted stock provides value even if the stock price declines or stays steady. Employees will also have the opportunity to sell their underwater and unvested options to JP Morgan for a fraction of their current face value.

There are several significant elements to this development:

- The story generated enormous publicity (six major stories in the *Wall Street Journal* in one day). Most of the stories suggested that options may be declining as a compensation strategy, but most also said that Microsoft's strategy was significant as well in that it continued the tradition of broad-based employee ownership. The tremendous publicity will itself help shape future corporate decisions.
- Microsoft is so large and such an industry leader that many other companies will at least seriously consider this approach.
- Microsoft itself very explicitly stated that it believed broad-based ownership as a key to the company's success.
- Microsoft is one of fewer than 10 companies to choose to expense not just current, but prior option grants. This may give it a chance to reconsider how it expensed these grants in the past for footnote disclosure. More moderate assumptions about volatility, as well as its new dividend policy, could lower the cost charged to earnings (the cost of options in the standard formula is greater with higher expected volatility and if no dividends are paid).
- JP Morgan's arrangement with Microsoft to purchase underwater options provides an intriguing possibility. Other investment banks have indicated a strong interest in entering this market. What makes this market work is the different risk profiles of employees and the investment banks. JP Morgan can buy underwater options, then reduce its risk through hedging strategies that would not be practical for most employees. So options that might seem 'worthless' to employees have greater value to an investment bank. For these plans to work, however, companies must make their options transferable. This means incentive stock options cannot be used (by their terms, they are not transferable in this way). Most non-qualified options are not transferable under the grant agreement, so companies would need to change that.

Whether other companies will jump on board the restricted stock bandwagon is unclear. A recent Mercer survey of 134 large companies indicated that 57% had already added equity programs that did not exist before, but the substitution of restricted stock for options in a broad-based plan is still rare (companies might be substituting restricted stock for options for some executives, for instance). A reasonable supposition is that some (but not a majority of) more mature companies will move in this direction, while younger and more volatile companies, where options are more valuable, will not.

FAS 150 and ESOPs: Still Up in the Air

There is still no consensus on just what the Financial Accounting Standards Board (FASB) really means by its new FAS 150, an accounting protocol effective from May 2003 that requires companies to record a liability on their balance sheets for mandatorily redeemable obligations, including 'puttable stock'. On the one hand, shares held by ESOP participants and put to the company certainly seem to fall within this definition. On the other hand, the statement explicitly exempts ESOPs following current AICPA standards for ESOP accounting. Moreover, it is unclear whether this would apply to plans in which the shares are redeemed prior to an employee leaving (as would be the case in S corporations and companies in which the by-laws state that "all or substantially all" of the stock be owned by employees) or plans in which the employee only owns the shares on a temporary basis (the IRS, in rulings on S corporations, has said that such transient ownership does not constitute ownership for S corporation purposes, for instance).

Unfortunately, FASB allowed for no comments on this new procedure and clearly did not have ESOPs in closely held companies in mind when drafting it. Some accounting firms have told clients they believe it may require showing repurchase obligations as a balance sheet liability; others have said they believe it does not. If this standard were adopted, some companies could face significant unanticipated problems. Some loan covenants, for instance, would be violated because the company could show a negative net worth or at least a debt-to-equity ratio below what the covenant specifies. Unless these agreements can be renegotiated, ESOP companies could conceivably have loans called. It is unclear how or if this matter is going to be addressed; there are no current plans for FASB to address it specifically.

By Corey Rosen, Executive Director, National Center for Employee Ownership

choose between expensing and disclosure.

The beauty of the current accounting standard is that it avoids a mandatory, uniform approach. The compensation system that works for one company may well not work for others. Microsoft itself supports such flexibility, as articulated by Senior Vice-President John Connors, "We agree with others in our industry that there's no one-size-fits-all approach when it comes to equity compensation programs and the resultant accounting for them. Every company has a unique set of circumstances, and this is the appropriate accounting treatment for our new compensation plan." (Press Release, July 8, 2003).

Companies will continue to seek ways to attract and retain smart, innovative employees. Many will continue to use broad-based stock option plans as well as other rewards for success—including pay increases, bonuses, direct grants of stock, and career promotions.

Just because Microsoft has chosen to end its use of stock options, it does not remove the value of the tool for other companies, particularly younger companies that do not have the kind of resources as Microsoft. For established companies like Intel and Cisco, stock options are a way to tie employees' interests with the financial health of their company.

Microsoft is a mature, well-established company with a large amount of cash on hand. Mature companies often can and do approach employee compensation differently than young, cash-starved ventures. *The New York Times,* confirmed this in a piece dated July 25: "That move was widely interpreted to be an acknowledgment by Microsoft that it was maturing as a corporation and that its compensation packages had to tilt in a new direction." And in Microsoft's own words, "Every company has a unique set of circumstances, and this is the appropriate accounting treatment for our new compensation plan." (Press Release, July 8, 2003).

The move, a result of a year of internal review, largely reflects the fact that many employees who have joined the company in recent years hold options with strike prices that are above the current value of Microsoft's shares—making them worthless, or 'underwater'. As part of its new plan, the company hopes to help employees realize some value on the worthless options by selling them to a financial institution. Under that voluntary plan, employees would receive cash from that sale which reflects the strike price of their options and Microsoft's current share price.

For established companies like Intel and Cisco, stock options are a way to tie employees' interests with the financial health of their company

Steve Ballmer, Microsoft's Chief Executive, summed up the rationale, "We want to be a magnet for the best people by paying smarter. We want to attract and retain employees by offering real ownership and great long-term financial incentives. And we want to ensure that our senior employees' total compensation is even more closely linked to growth in the number and satisfaction of our customers." (Press Release, July 8, 2003)

I am against the notion that corporate scandals of the past few years were fueled by stock options. The fraudulent bookkeeping, criminal behavior, and secret deals caused the recent corporate scandals. Broad-based stock option plans did not. Even if regulators had required expensing of stock options years ago, that would not have prevented the problems with Enron, WorldCom, and their brethren. The corporate scandals have, however, provided some people a way to use the stock option expensing movement as a shorthand for redirecting blame and enacting an 'easy' solution.

In the technology community, broad-based stock option plans have been used to attract and retain talented employees and to provide an incentive for rank-and-file workers to help their company succeed.

We remain committed to broad-based stock option plans, to ensure that rank-and-file workers benefit from broad-based plans, and to accurate and transparent accounting. Mandatory expensing of all employee stock options, however, will discourage broad-based plans, will penalize rank-and-file workers, and will lead to inaccurate and unreliable financial statements.

Proponents of broad-based stock options defend their use as a way to tie employees' interests with the financial health of their company. They argue that expensing them does not make sense, since they are really an expense to shareholders that is taken into account by the increased dilution in the number of total shares outstanding. Members of the International Employee Stock Options Coalition also say that there is no way to accurately record their value, so that expensing them will make a company's financial statements prone to errors.

The views expressed are the personal views of the participants and not necessarily of the organizations they represent.

INDIAN BANKS

Collaborative network

Inter-bank networking is gaining prominence among the Indian banks. The ATM sharing policy adopted by the banks is offering huge benefits and at the same time posing some challenges.

Recently, four of India's top banks, UTI Bank, Citibank, IDBI Bank, and Standard Chartered Bank, have formed an alliance called 'Cashnet', to share their Automated Teller Machine (ATM) network. The alliance would allow the customers of the four banks to withdraw money from any of the ATMs of the four banks (1300 in total).

Though the concept of sharing of ATM networks was not new, it has not been successful. In 1997, some of the banks under the Indian Banks' Association (IBA) came together and formed an ATM network called 'Swadhan'. But the effort failed to increase the sharing of the ATM network. What could have prompted the new initiative of the four banks even after the failure of Swadhan?

The beginning

In the past, growth of banks was associated with opening of new branches. In many cases, banks were opened only from the social point of view. However, the fixed cost of running these branches was very high. In contrast, an ATM only requires a box, which constitutes the hardware, through which transactions take place and a small place to locate the box. As a result, the cost incurred by the bank for transactions carried out through ATMs is lowered significantly compared to that of the transactions carried out through the branches. With less investment, banks could easily increase their presence and customer base. Hence, banks, mainly the private banks, started their own ATMs, as banks with ATMs are perceived customer-driven. ATMs were also considered as a technology differentiator, as they allow customers to withdraw money at their convenience without any hassles and without visiting the banks.

One of the reasons behind the failure of Swadhan was bad timing. As the technology of most of the member banks was not in place, the number of issued card bases was small and connectivity cost was also high. Swadhan was also operationally uneconomical as only 90 monthly transactions per ATM took place on an average. Vinay K Gupta, Business Head, Retail Banking, Global Trust Bank gave three reasons for the failure. First, "the cost of the ATM, leased lines and other networking equipments were very high in those days. As such, the cost of transaction on a shared network was high. Most banks found it difficult to either absorb the cost or pass it on to their customers." Second, "most of the participating banks were not sure of the quality of service delivery. They did not want their customers to have a 'bad' experience." Third, "the idea of an ATM itself was new. Many banks were not convinced that ATM was a 'must' for their customers."

The present situation

The situation today is entirely different. Banks say that 50% of their customers use ATMs for simple transactions like withdrawing money and checking their balance. 45 transactions a day per ATM few years ago, has increased to 250 per day. The issue of technology differentiator is fast disappearing, with ATM technology now being seen as a necessity. Use of credit cards has also increased considerably. A growing percentage

> **From a macro perspective, sharing of network avoids clusterization of ATMs and therefore wastage of precious capital.**
>
> **Sameek Bhargava**
> *Head, ATMs*
> *Card Products and*
> *Merchant Acquiring*

of urban people prefer banks with ATMs. As a result, banks with lesser number of ATMs are losing customers to the banks with a larger number of ATMs. Cost of deploying an ATM has also come down considerably. With the advancement of technology, the cost of ATM transaction is only Rs. 11 compared to Rs. 150 for a branch transaction. To remain cost competitive and to serve the customers in a better and speedier way it has become imperative to install ATMs. However, not all banks, especially the smaller banks, achieved the objective of establishing a large number of ATMs. On the other hand, banks with a large installed base of ATMs found that their total number of transactions is not enough to fully utilize the potential of the ATMs.

In addition, the trend in India is that ATMs are mainly located in the urban areas while they are thinly spread in the semi-urban and rural areas. Places like malls, railway stations and hypermarkets are chosen to set up ATMs where the number of footfalls is high. In some cases, there are a large number of ATMs within a radius of half-a-kilometer in the urban areas. In Mumbai there is more than one ATM for every 10,000 people. The spread and density of ATMs in geographical areas remain uneven.

Through sharing of ATMs banks could easily penetrate the rural and semi-urban areas of India, where there is large latent potential

The benefits

In such a scenario, sharing of ATMs will provide a win-win situation for both types of banks. Banks that do not have a large base of ATMs and those that have a large base of ATMs. Through sharing of ATMs banks could easily penetrate the rural and semi-urban areas of India, where there is large latent potential. Sameek Bhargava, Head, ATMs, Card Products and Merchant Acquiring, IDBI Bank opines, "from a macro perspective, sharing of network avoids clusterization of ATMs and therefore wastage of precious capital for competing investment priorities. It also shifts the nature of deployment from acquisition-based to transaction-based as shared networks introduce a level playing field in terms of distribution size. Transaction-based deployment increases thus pushing down per transaction costs over a longer term which ultimately benefits the customer." V V L N Sastry, Country Head, Firstcall India Equity Advisors Pvt. Ltd. says, "Gaining new customers through ATM network irrespective of branch network. Other benefits will be to network with other banks in order to reach existing customers in the nuke and corner, to provide flexibility, scalability, stability, maturity and auto-negotiation across the banks and to provide one stop service."

For smaller banks sharing of network would give them the access to large number of ATMs without the banks investing a large amount in ATMs. It costs about Rs. 13 lakh to install a new ATM, so installing 500 ATMs would cost a bank around Rs. 70 cr. In addition, cost of maintenance is around Rs. 15 lakh to Rs. 18 lakh annually. Such access will help them to attract new customers. In this context, Bhargava says, "large issuers (without large base of ATMs) need a greater ATM base to retain customers and migrate more and more transactions to the electronic format, exploit geographical synergies, no technical expertise is required to deploy and manage own ATM network and (saving) in financial resources."

For the big players, the benefits are also there. Gupta views, "banks with large base of ATMs will be able to utilize their ATMs to full capacity. They can also earn valuable non-fund income by offering their ATMs to the customers of other banks (have-nots)." Bhargava says, "tie-ups in increasing utilization of spare capacity, shared networks often offer value-added services and professional outsourcing options for the bank end." According to him, "IDBI Bank will have ATMs between 400 to 700, because beyond this size it makes sense to selectively leverage a larger shared network on a variable pricing model." Sastry, also agrees. He opines, "the usage of ATMs will increase with the number of customers of various banks using a single point of ATM and share the bandwidth and infrastructure and ATM hardware facilities (thereby spreading the total costs over large number of members)."

> **"Banks with large base of ATMs will be able to utilize their ATMs to full capacity."**
>
> **Vinay K Gupta**
> *Business Head*
> *Retail Banking*
> *Global Trust Bank*

The challenges

There are a few issues, like how successful the shared network system will be. First, whether customers will be willing to pay the charges required while using another bank's network. A customer of Standard Chartered Bank has to pay Rs. 27 while using a UTI Bank ATM. There is also variation in the rate of charges. Bank of India will charge only Rs. 10 from customers of other banks for using its network (Bank of India, Union Bank of India, Syndicate Bank and Indian Bank have also formed an ATM network sharing alliance). He opines, "customers may question the surcharges being

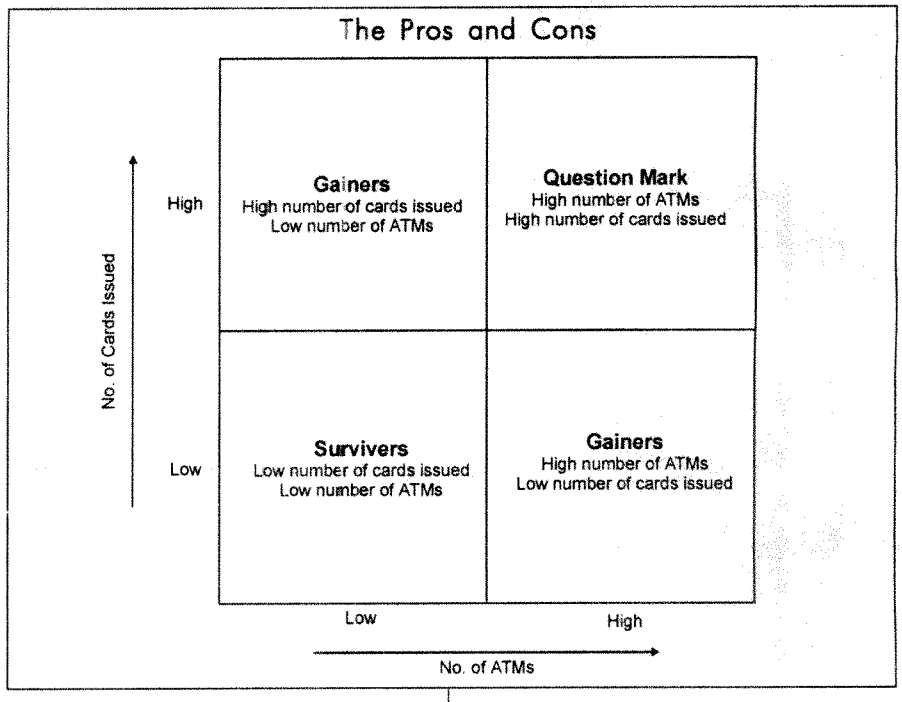
levied by their bank for its inability to set up its own infrastructure for ATMs and making them to pay surcharges, which may lead to banks losing customers. Also, banks sharing the network have a danger of losing the customer loyalty to the lead bank, which owns the network."

However, Gupta also pointed out that "in a way shared networks are already working. Many banks now offer Visa or MasterCard debit cards, which can be used at other banks' ATMs. Customers pay a fee of about Rs. 50 for each such transaction. Debit card transactions on other banks' ATMs are on the rise, which suggests that customers are willing to pay for convenience. In the case of shared ATM networks (other than Visa and MasterCard), the charges per withdrawal are likely to be much lower than the charges being levied by Visa or MasterCard. Moreover, each bank will be free to decide whether it wants to absorb the cost or pass it on to its customers."

Second, the pattern in the growth of the ATMs, which remain urban-centric and high traffic areas. Reserve Bank of India has questioned the usefulness of locating the ATMs only at the same locations by the banks. According to Gupta, challenges could also be, "hammering a common agreement among six or seven or more banks. Each bank will have to protect its interest, yet agree on a common platform, such as establishment of an operator who will control the operations, agreement on revenue and cost sharing, settlement mechanism and choice of settlement bank, choice of technology which is compatible with the technology used by participating banks and to establish a mechanism to handle complaints and customer queries."

"In future ATMs in India will be influenced by the latest trends taking place internationally.

V V L N Sastry
Country Head
Firstcall India Equity Advisors Pvt. Ltd.



Outlook

According to Sastry, "in the future people might carry around one card only, which would be used as a driver license ID, medical information, credit card, and cash. At the same time, ATMs in India will be influenced by the latest trends taking place internationally like exchanging e-cash to real money, honoring Net cheques, smart cards and electronic purse.

On the other hand, Bhargava opines, "two or three well run shared networks will survive and gain dominance. Large retail chains and departmental stores will also deploy their own ATMs, where they will tie-up with a bank to own and manage the cash. In the future, banks will focus on the value that they create on an ATM network rather than ATM networks. Towards that direction, IDBI Bank has launched the first ATM Web-based services called 'ATM Next', where customers get to see cricket scores, horoscopes, emergency numbers and so on. It has also introduced EASY Fill, which is India's first online prepaid top up service through ATMs and SMS. It is also the first bank in India to provide customers instructions on how to use ATMs through audio in various regional languages."

Two banks with the largest base of ATMs, State Bank of India (SBI) and ICICI Bank haven't joined any alliance or formed separate alliances. They are still going alone, because they view that proprietary approach enables banks to build brand recognition and retain control over the distribution strategy. However, globally no bank has remained alone without joining an alliance. There is no doubt that the sharing of ATM network has started altering the face of banking and in future the sharing will only increase with the customers being the ultimate winners.

Anindya Roy

Reference # 1-2003-09-10

CORPORATE RESULTS

Back to glory

After remaining dormant all these years, Indian corporate sector is once again in the limelight. In the fiscal 2002-03, India Inc. has exhibited outstanding performance. It has recorded the second highest growth in net profit of 58% after recording a profit of 68% in 1994-95.

While major global economies are still in the process of rearranging the wreckages created by economic evils like Gulf War II, SARS and terrorist attacks, it's party time for corporate India. After a prolonged gloomy economic scenario and downsliding profits, India Inc. at once has taken a U-turn to convert soaring profits into roaring profits. Unaudited results of around 1,581 companies recorded a net profit of Rs. 43,816 cr, a 57.84% growth, when compared to Rs. 27,759 cr the previous year. According to Central Statistical Organization (CSO), Q2 GDP of FY 2002-03 has posted a growth rate of 5.8% in spite of zero growth witnessed in agricultural sector. This reflects that industrial and services sector have grown extraordinarily to compensate the shortfall in agricultural sector growth. While the CSO forecasted a growth of 5.00 for the FY 2003, the actual real GDP growth rate for first half of the fiscal 2002-03 was 5.90. Barring some sectors, similar trends were observed across all sectors. Sectors like banking, automobile and automobile ancillaries and IT have exhibited outstanding performance and helped India Inc. to outperform its global counterparts.

Overcoming hurdles

Indian corporate sector that was suffering from problems like overcapacity and huge costs has learnt to generate funds internally. Arun Jethmalani, CEO, Valuenotes.com, says, "There are three key factors responsible... firstly, demand has finally caught up with the overcapacity hangover from the mid-1990s. Secondly, falling interest rates have given companies an opportunity to replace costly debt with cheaper funding. Thirdly, many companies have forced to focus on cost-cutting measures, which is now paying off."

This was possible because of certain internal and external factors. While low interest rates and increased dependence on exports constitute the external factors, ruthless cost cuts and effective working capital management are the internal factors. While Indian corporates have been rebuked for not focusing on exports, excess capacity and downsliding profits have forced them to look for new markets and focus on exports. If we look at the largest 100 companies by sales, the exports to sales ratio for the past four years has raised from 7.6% in 1998-99 to 11.6% in 2001-02. What does this increasing trend in exports imply? This trend decreases the sensitivity of Indian companies to the domestic business cycles. Companies that were getting low margins in the domestic industry, by relying on exports can increase the profits. Another major implication for Indian corporate sector is that exports thrust increases quality consciousness among companies and increases the opportunity for reaping benefits in the form of cost-cuttings as a result of their global value chains.

Another step taken by companies to weather recession is effective working capital management. High inflation rates, as a result of which, profit margins came under pressure, have forced manufacturers to refocus on their internal processes and find ways to reduce costs so as to earn profits at every level. For instance—Ashok Leyland. The recessionary trend in the late 1990s had made executives at the company to hasten their efficiency improvement programs that were aimed at making the company globally competitive. In 1997-98 the company initiated a production alignment program aimed at controlling inventory levels. By adopting measures like e-procurement, rationalization of suppliers, Ashok Leyland could achieve material cost cuts of about a percent each year ever since these programs were initiated.

Another major boon for companies that were encumbered with excess of high-cost debts was the low interest rate regime. With an intention to help companies survive the recession and to support industrial growth, RBI has initiated to cut interest rates. The recent annual Currency and Finance Report of the RBI revealed that between March 1998 and February 2003, bank rate and repo rate were cut by 425 basis points and 250 basis points respectively. Further, CRR was reduced by 550 basis points over the same period. The companies have soon utilized the opportunity to restructure their debt and replace their high cost debt with low cost debt. This has reduced their annual interest payments and has increased their profit margins. For instance, Phillips was constantly focusing on debt and was successfully able to reduce its debt burden substantially. Phillips reduced its debt to Rs. 66 cr in the year ended December 2002 from Rs. 127 cr during the same period in 2001. Similarly, interest expenses were reduced from Rs. 23.8 cr in December 2000 to Rs. 7.6 cr in December 2002. Another best example of debt restructuring is Tisco. Tisco was able to lower its debt-equity ratio from 1.75 in first half of 2002 to 1.57 in first half of 2003.

Double bonanza

If this was the direct impact of the low interest rate regime, there has been indirect impact on the financial position of companies. Debt restructuring and low cost debt have improved financial prudence of companies and this has, in turn improved debt-servicing capabilities of companies. Increased financial prudence and profit margins have also encouraged companies to declare huge dividends to their shareholders. Though this happened partially because of dividend tax exemption in the budget for the fiscal 2003-04, increased profit margins have also played a role in this trend.

It has also been observed that many companies have declared dividends double or even more than double the amount that was declared in the fiscal 2001-02. Companies that declared huge dividends include BPCL, Tata Steel, Infosys Technologies Ltd., Satyam Computer Services, Bank of Baroda, Kochi Refineries, Chennai Petroleum Corporation, Dr. Reddy's Laboratories, Sun Pharma, Dabur India and Andhra Bank. In the case of Tisco it has announced a dividend of 80%, double the amount that was declared in the previous year. In the current year Tisco will pay a dividend of Rs. 295 cr. This has been possible because of the impressive performance exhibited by the company during the fiscal 2002-03. Tisco's net profit for the fiscal 2002-03 was Rs. 1,102 cr, when compared to Rs. 205 cr during 2001-02. Tisco's net sales increased from Rs. 7,597 cr in 2001-02 to Rs. 9.793 cr.

Perhaps, not satisfied with huge dividend payouts, Indian corporates have exhibited their zeal to satisfy their shareholders by declaring sumptuous bonus issue. Improved financial position has resulted in overflowing corporate coffers. Says a Mumbai-based leading market analyst, "Most companies currently enjoy a strong book-value position making them appropriate candidates for bonus issues." To capitalize these bulging reserves and to reward the shareholders, who have been patient, the losses and unattractive dividend payouts by the companies, India Inc. has declared bonus issues. Mirc Electronics, Exide Industries, MphasiS BFL have announced liberal bonus issue of one bonus share for every share held by the shareholders.

A Better Performance

(Rs. cr)

	2003	Change (%)	2002	Change (%)	2001
Sales	8,69,268	15.1	7,55,071	5.9	7,13,148
Other Income	40,355	25.8	32,080	19.7	26,804
Expenditure	6,82,250	11.4	6,12,174	4.7	5,84,476
Raw Material	3,50,978	41.5	2,47,988	2.0	2,43,027
Staff Cost	59,399	8.9	54,504	7.8	50,539
Interest	1,13,281	1.9	1,11,153	11.7	99,481
Gross Profit	1,47,828	34.9	1,09,533	16.7	93,897
Depreciation	43,892	12.9	38,865	13.0	34,394
Tax	28,798	38.4	20,810	45.5	14,300
Net Profit	67,194	52.2	44,156	5.8	41,720

Source: CMIE

Attractive dividends and liberal bonus announcements have increased stock market activity and this has resulted in stock price rally in many cases. This is evident from stock price movements of the companies that have announced huge dividend payouts and bonus issues.

So far so good

Barring some sectors, automobile, auto ancillaries, banking and IT have recorded amazing growth figures. While the enactment of Securitization Act enabled banks to reduce their NPA levels and this in turn helped them to increase profits, new product launches and increase in exports have helped the automobile industry. Other major factors that have contributed to the rise in profits of banking sector include increased focus on retail financing and fall in interest rates. Fall in interest rates helped banks to reduce interest rates on their deposits and this has in turn helped to lower cost outgo on interest cost. Also, banks have increased focus on retail lending.

Even IT companies after leading the market rally in the mid-1990s have calmed down and have taken a U-turn to touch their lows. The IT sector this year has recorded a growth of 21% over last year. Despite this growth, profits are still under pressure. The reasons for the pressure include appreciation of rupee against dollar, slowdown in the US, which accounts for 66% of software exports and low corporate spending on IT. To survive these problems, IT companies have started to focus on new areas like management of IT infrastructure on clients at far-off locations, BPO, and open source software. To dilute the exposure to US companies are now focusing on Europe, Asia-Pacific and also under-penetrated areas of Latin America. Despite the ongoing impressive scenario, one question remains unanswered. Is this growth sustainable? If one looks at the Q1 results for the fiscal 2003-04, corporate India has fared well and recorded comparable profit figures. This gives us a ray of hope that the growth trend is sustainable in the future.

Sharat Jutur

Reference # 1-2003-09-11

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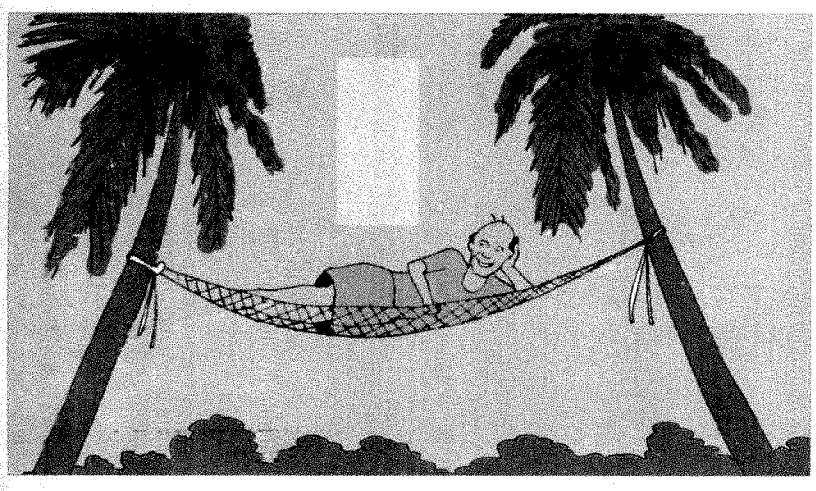
Magnum Intergrafiks/03

INDIAN PENSION FUNDS

In the nascent stage

Pension fund in India is a pasture, which is still unexplored as compared to other economies of the world. The pension reforms are expected to facilitate a healthy growth supporting both the economy and individuals.



The famous adage, "A stitch in time saves nine" fits the lifestyle of Indian population, which consists of middle class as a major proportion. With the rise in the average age—a result of improved medical sciences—pension fund market is all set to witness some big changes. Though the pension sector contributes in many ways to the economic growth of the country, India has been deprived of its benefits due to the lack of government support and rigid norms.

However, the scenario is fast changing. The liberalization of financial services, more specifically, insurance industry has resulted in new players venturing into the market. As a direct result of this liberalization, the pension fund market is also witnessing a lot of activity. Traditionally, it was a sector dominated purely by the government, as it was the only body that used to contribute towards pension liabilities through the fiscal budget. The pension option was available only to the government employees and few PSU employees. Very few private sector companies provided any kind of social security for their employees. The entry of new private players into the market has enabled the majority of the population the choice of providing for their future.

Commenting on the developments taking place in the pension sector, Prof. V K Sarma, Faculty in Insurance, ICFAI Business School, Hyderabad, former secretary of Indian Institute of Insurance and AGM (Retd.), United India Insurance, says, "Pension sector in India, which is neglected so far, has started receiving proper attention, now. The government is realizing its mistake of not funding its pension liabilities and 'pay as you go' system. Undoubtedly, the pension sector is changing fast in a positive direction."

Unexplored avenue

According to the CII estimates, by 2016, the senior citizen population in India is expected to rise by almost 107% as against a growth of 49% in general population. By that time, 9% of the population will be aged above 60 years and the life expectancy of an Indian is likely to improve to 80 years. Old Age Social and Income Security or OASIS report calculated that the Central Government is likely to shell out Rs. 27,183 cr for pension payments alone in 2015. The report also said that the government liability is expected to rise 10.7% compounded annually from 2015. Before the liberalization of the insurance sector, only 3% of the population was covered by pension through three basic schemes—EPF, EPS and PPF.

Despite rising population (general and senior citizens) pension sector is still untapped in India as compared to other countries. Various factors have contributed to the underdevelopment of pension sector in India. Till recently joint family system prevailed in which, elders were taken care of by their children and other family members, as it was a low cost affair. However, with the nuclear family structure replacing the joint family structure, the responsibility of providing a safety net to the elder member is being transferred to the state or the onus lies on the individual himself. Sarma is of the view that "With the structural changes taking place in the Indian economy the attitude and outlook of people has also undergone a change. There is demand and need for liquid cash even in rural areas. The credit-based lifestyle has completely changed for common man. Credit cards and bank credit is more suitable for earning population and business classes. Pensioners can depend only on supply of liquid cash on regular basis."

The vast unexplored potential of the pension sector is attracting new players. Private players are offering various pension schemes that suit

the requirements of various individuals. Majority of the funds are eyeing the vast private sector employees who are not provided by any form of pension earlier.

However, the growth of the pension fund market in India is going to be determined by the way the government regulates and organizes the pension fund market. The regulation of this sector through a regulatory body (Pension Fund Regulatory Authority) is important for its future growth. The Indian Government has already announced its intentions about setting up a regulatory body to oversee the growth and regulation of the market. The pension reforms contemplated by the government is expected to address specific issues that have resulted in the poor growth of the market so far. Once the reforms process is through, the pension fund sector is likely to witness the same growth rates of developed countries.

It is expected that the mutual funds, banks and other financial intermediaries will be operating in the pension fund sector thus providing the investors a wide choice. The differential factor here is going to be the interest rates and returns. Sarma argues that the interest rates should be supporting the objective of the pension system when he says, "There should not be any unfavorable or negative consequences of an interest rate at 9.5% or 9% on pension funds. Whatever may be the percent of interest, the pensioners should be able to maintain their lifestyle for which they are accustomed to during their lifetime."

From government control to...

Undoubtedly the pension sector in India has been dominated/ controlled by the government. The government so far has concentrated on providing a social security system to its employees; the new initiatives of the government indicate its willingness to extend its safety to ageing population of the country. While the private players will compete and provide services to the general population who were deprived of the safety net so far (though small portion of the population have planned for their future requirements), Indian Government has announced schemes for the poor and rural population.

Recently the Prime Minister (PM) announced the old age pension scheme for elder citizens. The old age pension scheme of the LIC, called the Varishta Pension Bima Yojana, will provide a pension ranging from a minimum of Rs. 250 to a maximum of Rs. 2000 per month. For the minimum pension a lump sum payment of Rs. 33,335 has to be made while for maximum one needs to pay Rs. 2,66,665. The assured rate of return worked out by the LIC is 9% per annum. In case the LIC earns lower returns on the corpus of the scheme, the government will step in to make up the shortfall. Apart from this, up to 75% of the total deposited premium will be allowed in the form of a loan after the policy has run for three years. The exit option is after the completion of 15 years.

Though the PM has announced this policy, there are some questions raised whether this policy is really meant for the poor? An individual investing Rs. 33,335 or Rs. 2,66,665 would be getting a return of Rs. 250 per month or Rs. 2000 per month respectively. Would this monthly income of such a meager amount really make a difference in the lifestyle of a common man is highly debatable. Another issue in the scheme is related to the government intervention. It is announced that in case of any gap between the earnings the Central Government would provide subsidy. Apart from this attempts are being made to allow only one individual in a family to take benefit in the pension scheme and preferably include both husband and wife, who may invest their savings. There could be two earning members in a family with a need for pension benefit. These concerns are raising doubts about the effectiveness of the scheme. Sarma suggests a few points to improve the scheme, when he says, "It is basically a good plan but the loopholes can be improvised in a number of ways:

- It shall be made tax-free.
- There need not be any cap or ceilings on the amount of pension purchase price.
- The pension should have option not to ask for return of purchase money but receive a higher amount of pension for life covering both him and his wife. As pointed out this should be as per his choice.
- In addition to LIC other players also should be allowed to offer such schemes with subsidy from the government.
- The agency commission should be increased so that this scheme is vigorously marketed even in remote rural areas.
- Post offices should be involved in implementing this plan since they are already dealing with other savings plans.
- They should be provided necessary manpower and remuneration through incentives."

Private players are offering both defined benefit schemes and defined contribution schemes to the investors based on their risk appetite. Sarma opines, "There is room for both defined contribution and defined benefit methods. People who prefer to take risk may opt for the former and people wanting to play safe prefer the latter. In between there are a number of permutations and combinations and people may be allowed to switch from one system to the other."

The future outlook for the industry appears to be bright. Sarma sums up, "the future appears to be bright as the sector from the economic point of view will create enormous employment opportunities, investments to capital markets, income and happy retired life for pensioners."

Manish Mishra

Reference # 1-2003-09-12

RUSSIAN OIL

The emerging leader

The Russian oil industry is back in action after a brief slump. The industry has been witnessing many alliances in the recent past giving rise to bigger oil houses. These developments pose an obvious threat to its business archrival, OPEC.

Russian oil industry has been witnessing a lot of action in the recent past. It is into rapid expansion and globalization going ahead with activities like, mergers, and acquisitions and allowing foreign entrants into the industry. Marathon Oil Corporation and Khanty-Mansiisk Oil Corporation (KMOC), Yukos and Sibneft, Tyumen Oil Company and British Petroleum are a few of the oil giants that have merged recently to create stronger markets on the global front. Russian oil production is back to the front line and the industry has built a strong platform of its own where it can position itself as a healthy alternative to Organization of Petroleum Exporting Countries (OPEC). All these developments, put together, are becoming a cause of concern to the OPEC cartel, as Russia is no more coordinating its oil policy with OPEC.

A brief overview

The 1980s were the heydays for Russian oil industry when it was the world's No. 1 oil producer. In the early 1990s, Russia's oil industry witnessed a brief southward movement. Year 1992, witnessed the signing of the crucial Yeltsin's presidential decree on Russian vertically integrated companies. This followed a rapid privatization process in oil and gas industry resulting in a dozen oil companies that emerged as vertically integrated entities.

In 2000, the oil industry continued to reap dividends from the cost deflation that resulted from the 1998 slump and high oil prices. Official statistics for 2000 show that oil and gas production reached 6.46 million bpd (barrels per day) that amounts to 360,000 bpd higher than the figure in 1999. In absolute figures the exports reached a total of 2.93 million bpd, which stood at 44% of total production. To facilitate the growth process 3,330 new wells were put into operation representing a 66% increase over the year 1999.

The OPEC's woes

As Russia is back to its heydays in oil production, this has passed a shiver down the spines of the countries comprising of the OPEC. Russian oil companies invested heavily in production and started to increase output significantly in the second part of 2001.

The total oil production by the non-OPEC countries amounts to around 63% of the total global oil production. Russia's growing oil exports have again come into conflict with the OPEC oil cartel, prompting warnings of a possible price war to control the world market. This situation has prompted the Organization to put a demand before Russia to curb its oil production.

In response, despite a heavy reluctance from the industry, Russia promised to do so in the first quarter of 2002 and reduced the production by a significant 150,000 bpd barrels per day, though the evidence of Russia's compliance with the OPEC deal is not clear-cut by any means. But Russia said that it was not ready to respond to OPEC's demand for a continued squeeze on Russia's oil exports into the forthcoming times as cutting output would lead to the country losing market share and put an unsustainable pressure on its budget. Rilwanu Lukman, President OPEC, says that they have the reserves and the capacity to respond to any eventual price war with Russia. He says that OPEC doesn't want a price war, but warns at the same time by saying that it doesn't want to lose a war declared by others.

Another cause of concern for the OPEC is the growing and healthier relation between Russia and United States. The cartel is bothered by Russia's new energy cooperation with the United States, which has

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Qualified Professional Scheme	Doctors, Engineers, Architects, Chartered Accountants, Management Consultants etc.	To set up consultancy venture/ related activity for services rendered by professionals- purchase of equipment & other assets. Units can be set up in residential area to the extent permissible under master plan.	50 lacs	TL 32.50 lacs (65%) SL 10.00 lacs (25% or Rs. 10 lac max.) (NEF)	10%
Mahila Udyam Nidhi (MUN)	Women entrepreneur to set up proprietary/partnership units.	To set up new small/tiny Units.	10 lacs	TL 6.5 lacs (65%) SL 2.5 lacs (25%) (MUN)	10%
Relocation Scheme	Those who have been allotted plots by DSIDC.	Acquisition of land, building, plants & machinery and other assets.	50 lacs (incl. of working capital	TL 32.50 lacs (65%) SL 10.00 lacs (25% or Rs. 10 lac max.) (NEF)	10%
Small Road Transport Operators Scheme (SRTO)	Small transport operators to acquire upto 20 vehicles including existing, if any.	To meet expenditure towards cost of chassis, body, building, intial taxes, insurance and registration etc.	Overall assets not to exceed Rs. 12 Crores & Share Capital & reserves not to exceed Rs. 10 Crores.	Rs. 500 lacs for Companies/Cooperative Society & Rs. 200 lacs for proprietory/partnership firms.	15%

Ankur/22/2003

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Towards A Greener, Cleaner and Better Environment

been witnessing regular shipments by the second-largest oil company, Yukos. The imports from Russia have had an adverse effect in Saudi Arabia's share of the market, particularly for light crude, which is favored in the United States.

War and oil

The war on Iraq had an immense impact on the world oil markets in general and OPEC in specific. Experts opine that as soon as USA captures Iraqi oil, the world oil market as it appears today, will cease to exist. It is a widespread opinion among the analysts that after Gulf War II the OPEC might collapse. It is also expected to have a political motive behind this, as Iraq was one of the initiators of OPEC creation. The cartel was set up in a conference in Baghdad in September 1960. The Secretary General, OPEC, Alvaro Silva Calderon, in a press meeting earlier this year neither confirmed nor denied the possibility of OPEC breaking-up. That gesture was enough to raise the apprehensive opinions about the very survival of the cartel.

Russia is also thinking about changing routes in the world oil flows. This is due to Russia's failure to materialize large-scale oil supplies to the USA in exchange for the latter's investments in the former's mining industries.

As per the reports, the Russian Government considers Asiatic countries such as China, Japan etc., as its prospective clients and investors in the times to come. The sources suggest that Russia has already sprang into action as Russia and Iran discussed participation of Russian companies and enterprises in industrial projects on the territory of Iran. The latter had already confirmed its intentions of expanding its cooperation in the energy sphere. At present, Russian companies are already operating in Iran.

Hence, on the one hand, Russian oil and gas industry having lost the market share during the redistribution of the oil market done by the USA would definitely have the adverse affect.

On the other hand, OPEC with its very existence in doldrums after the war on Iraq has a rocky way ahead. Considering the stances of the two oil tycoons: OPEC and Russia, it is early to comment as to who will be hit harder. However, it can be observed that Russia is on its way cruising through the new horizons and healthy opportunities like the Asiatic countries and possibly the European countries as well, which spells a clear-cut advantage of Russia over the cartel.

K B S Kumar

Reference # 1-2003-09-13

Russian Oil and Gas Sector at a Glance

Company	Description
Lukoil Oil Company	Lukoil holds the credit of being Russia's No. 1 oil producer. As a global player Lukoil claims around 2% of total world output. In terms of proven reserves the company is among the world's top five publicly traded oil companies.
*Yukos	Yukos is a fully integrated oil and gas company headquartered in Moscow. It holds the credit of being one of the world's largest non-state oil companies by reserves and market capitalization. It is among Russia's largest publicly traded corporations by market capitalization.
*Sibneft	Sibneft is among Russia's largest integrated oil companies and one of the world's top 20 private sector oil producers in terms of reserves. The company's core upstream assets are concentrated around Noyabrsk in Western Siberia.
Sidanco	One of the leaders of Russian oil and petrochemistry industry, with minor participation of BP.
Gazprom	World's biggest gas company which accounts for 94% of Russia's gas production (23% of the world output), and also generates 25% of the national budget revenue.
TNK	TNK's primary oil fields are located in the Tyumen region of western Siberia, the largest region of underdeveloped hydrocarbon reserves in Russia. The wells are highly productive, with high quality sweet crude oil.

* The top Russian oil producers Yukos and Sibneft announced a mega-merger recently that would turn the resultant company into the top global player in the oil industry. The deal stands to be the largest merger in Russia's emerging market economy, which will create the world's fourth-largest private oil producer.

Yukos, Russia's second-biggest oil producer behind Lukoil, will play the dominant role in the new company, to be called YukosSibneft Oil Company after the agreed acquisition of Sibneft. The merger is expected to be completed by December 31 according to an announcement made by Sibneft.

Source: The Moscow Times *special collection.*

INTERNET SEARCH

Battle in the cyberspace

By acquiring Overture, a paid-search provider, Yahoo! has openly challenged Google's top position and has also put Microsoft in an awkward position.

Since the bursting of the tech bubble, three years ago, the industry hasn't seen much activity on the M&A front. But now the so-called 'drought' seems to be over and the search engines are leading the pack for the latest round of consolidation. Experts now believe that the various players in the market would clamor into a consolidation phase, where those who don't look for prey will become the prey.

In keeping with this trend Yahoo!, which managed to survive the tech shakeout, is buying Overture, a paid-search engine for around $1.6 bn. With this deal, Yahoo!, which has been fighting a bitter battle with rivals, is poised to take its archenemy, Google head-on for the top spot in the market. At the same time this purchase might give a persistent headache to its other rival, Microsoft's MSN.

All about searches

Yahoo! has seen a surge in profits in recent quarters mainly due to the continued popularity of its sponsored Web searches that give the sponsors' (advertisers') name along with some search results. Sponsored searches have become highly popular in recent years because they generate cheap hits than online advertising. Analysts believe that this market could be worth $5 bn in 2003. And, Overture, previously known as GoTo.com, is a specialist in this market. It has a business model that involves bidding by advertisers for the right to have their links displayed under specific search terms. The order of the links displayed with a search page is determined by the results of the auction.

Searches can be of two types algorithmic and sponsored. In the case of the former, the search results are listed as per the relevance. In such searches, a search query generates a list of pages ranked on the basis of the number of other websites carrying a link to that or any other mathematical algorithm. Whereas sponsored searches, or paid-searches, return a list based on the amount an advertiser has paid to have his website listed. Because, advertising revenue generated through such searches ensures a steady cash flow, paid-search engines like Overture are a few profitable ones in the search business. Yahoo!, MSN, Google, Inktomi and others are algorithmic search engines while Overture specializes in sponsored searches i.e., it provides marketing services through search engines. Sponsored search is a fast growing segment of online advertising. Advertisers pay for getting listed. In other words, search engines offering sponsored search services are like yellow pages on the Web.

Search-related advertising is the star of online marketing, with a sales growth way above any other in the online advertising market. Interactive Advertising Media states that sponsored Search (also referred to as paid search or commercial search) makes up almost 15.4% of the online ad market, estimated to be worth around $6 bn. Also, revenues in this segment rose, in 2002 over 2001, by almost 200% to $1 bn. The growth potential of this segment in the coming years is estimated to be high.

Yahoo!'s Overture

For Yahoo!, Overture is a priced catch. These days, when advertisers no longer consider Internet as the ultimate media to reach their customers, especially when the 'clicks' and 'eyeball' measures have largely lost their credibility, Yahoo! badly needed a money-spinner. Yahoo! has been making every effort to move away from its ad-based business model and is finding new revenue models to keep itself afloat in these dire times. During the booming 1990s ads made up 90% of Yahoo!'s revenues and most Web surfers preferred the free portal and search engine as their gateway to the Net. As Yahoo! realized the risk of overdependence on ads, it added new and improved features to its portal, providing personalization, auctions and shopping alternatives. Thanks to these shrewd moves, ads account for less than 60% of its revenues now. The company is trying to reduce its ad-sales dependence further. Overture is its latest move in the game of finding alternate revenue sources. With Overture in its fold, Yahoo! would get the best of search technology, which come with a patent backing. Another benefit to Yahoo! is that Overture literally is omnipresent in the search market. It owns AltaVista and Fast Search. It has partnerships with almost every search engine, from Lycos, Infospace to even Yahoo! and Microsoft's MSN.

But a more immediate goal of the acquisition for Yahoo! is to beat Google in the paid-search, and outsmart MSN in the Web-portal segment.

Ogling Google

Over the years, Google speedily captured the hearts of many a search user and grabbed the market

share from many a rival. It has built a strong brand at the expense of Yahoo!. In fact, Google runs most of the search queries on the Net.

However, even with Overture, Yahoo! might not be able to surpass Google. Overture has to depend on the portals, which carry its search engine. And, increasingly they are lobbying for more money to do so. Whereas Google has a huge advantage over Overture as it gets most of its search queries directly to its website.

After the deal Yahoo! might sever ties with Google, its three-year search partner. Because, Yahoo! considers Google its No. 1 rival and thinks that Overture can help it to displace Google from its top spot.

"Once the deal with Overture closes, Yahoo!, just like Google, will control the two key elements to search success: Good content to pull users in and good ads to help pay for the service. That will help Yahoo! to secure its future as a search destination," says Danny Sullivan, an Internet consultant and journalist who maintains the site, Searchenginewatch.com, for internet.com.

Then there is the interesting angle to this whole story of getting to the helm. Though the spotlight is on the rivalry between Yahoo! and Google, the real action may be between Yahoo! and Microsoft because with its clout, Microsoft can easily eat-up Google.

Once the deal with Overture closes, Yahoo!, just like Google, will control the two key elements to search success

The Microsoft angle

MSN is in a fiddly situation; it now has to depend on Inktomi and Overture, both Yahoo!'s (its staunchest competitors') acquisitions, for its algorithmic and paid search services. Though both Yahoo! and MSN have publicly stated that they will remain committed to the contract with Overture, till December 2004, even after the acquisition, in the long run, MSN has only two options—either to build the capabilities to run both kinds of searches on its own or buy those companies, which are good at them. True that it is in the interests of both parties to abide by the contract, because while, Overture has been very valuable for MSN, so is MSN for Overture, since it accounts for nearly 70% of its revenues.

But, like what happened with Inktomi, MSN would do well to develop sponsored search capabilities of its own. When Yahoo! acquired Inktomi, MSN's algorithmic search provider in December 2002, where though it had renewed the contract till December 2005 two months after the acquisition, it also started developing search capabilities on its own.

In the case of Overture, even though the contract provides for a walk away option for MSN in the event of a change of control of Overture, experts believe that Microsoft might not exercise that option till it finds a company or two which could get it the algorithmic and paid search capabilities. In any case, they say, that Microsoft has time till the fourth quarter, when the deal closes, to evaluate its options. Many industry observers feel that it may buy paid listings provider like FindWhat.com, AskJeeves or LookSmart. Some go to the extent of saying that Microsoft might prey upon Google. If that really happens, the search engine business would have an abundance of fiery action.

All along, just like Yahoo!, Overture has been under competitive pressure from Google. As a result of the aggressiveness of Google in promoting sponsored search services, Overture's earnings in the first quarter dipped to $11.1 mn (around 67% drop over the same period last year). So, it is a typical story of two companies, Yahoo! and Overture, having a common enemy, Google, getting together to fight against it. In this battle, though, a third party, Microsoft, might dictate the outcome.

C S V Ratna

Reference # 1-2003-09-14

The Deal

Under the terms of the agreement, each outstanding common share of Overture will receive 0.6108 shares of Yahoo! common stock and $4.75 in cash, reflecting an aggregate purchase price of approximately $1.63 bn, or $1.52 bn net of Overture's March 31, 2003 cash balance, minus the amounts earmarked for their two recently closed transactions.

Overture is the leading provider of commercial search having more than 88,000 advertisers globally as of the end of the first quarter of 2003. Overture also has an extensive affiliate distribution network that Yahoo! and Overture are dedicated to maintain and enhance, a world-class technology infrastructure in both commercial and Web search, and a comprehensive intellectual property portfolio.

With the deal, Yahoo! and Overture will be able to expand their combined products and services internationally. In the short run they might expand into Europe, Korea and Japan where both companies already have a strong presence.

Overture will become a wholly-owned subsidiary of Yahoo!, and its operations will remain in Pasadena following completion of the acquisition. Ted Meisel will continue to head Overture's operations and report to Dan Rosensweig, Yahoo!'s Chief Operating Officer. It is likely that the transaction will be completed by the fourth quarter of 2003.

Source: www.overture.com

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RESEARCH SUMMARY

Performance of Indian Banks During Reforms

Banking sector is the backbone of a country's financial system. The decade of the 1990s ushered in a number of reforms in the financial system in a phased manner. This research attempts to study the changes in the performance of Indian banks during this phase of financial liberalization.

The decade of economic reforms in India changed the face of the Indian economy. Specifically in the financial system, there have been perceptible changes. Some of the major financial reforms took place in the banking sector.

Gradual liberalization

Indian banking sector today is very different from what it was in the early 1990s. At that point of time the nationalized banks, the state banks and the old private sector banks were the only players. Among these the state banks and the nationalized banks commanded a dominant market share. Today the banking landscape has new private sector players, foreign banks as well as public sector banks that have raised capital through primary markets. All this was achieved through a process of liberalization, which started in 1991 and proceeded in a phased manner. By 2002, the main reforms including interest rate liberalization, reduction in reserve requirements, entry deregulation, credit policies and prudential supervisions were put in place.

The lending and deposit rates of commercial banks were liberalized. Interest rates were heavily regulated and were administered for all types of deposits (demand, term and savings). The lending structure, characterized by six loan categories was also regulated with the use of a minimum lending rate for each category. By 2000, the deregulation of the interest rates was more or less complete.

The reserve requirements for commercial banks were also gradually reduced. As a result of the reductions the CRR (Cash Reserve Ratio) decreased from 15% to its current value of 5% and the SLR (Statutory Liquidity Requirement) has decreased from 38.5% for domestic liabilities and 30% for non-resident liabilities to the current level of 25%—which is the minimum ratio of liquid assets to demand and time liabilities allowed as per the present legislation.

The third arena of reform is the easing of the entry and ownership restriction. Before the economic reforms the entry of foreign banks into the Indian markets was restricted. In addition, new private sector banks had not entered the system since the 1970s. Private ownership of public sector banks too was not allowed. There were some major changes in all these areas as a part of financial liberalization. In 1993, the State Bank of India Act was amended and the SBI became the first public bank to raise capital from public in December 1993. In 1994, it was decided that nationalized banks could raise up to 40% of their capital from the public. As a result of this change many of the public sector banks like Punjab National Bank, Andhra Bank etc., tapped the equity markets with IPOs and were well received by the markets. In 1993, the rules for the introduction of new private sector banks were introduced. As a result nine new private sector banks were founded between 1994-96. The total number of foreign banks increased from 24 to 42 between 1991-92 and 2001-02. The number of branches that can be opened by foreign banks have also been increased from 21 to 42. Presently the RBI is considering an increase in foreign ownership in Indian banks. This deregulation of the entry requirements ushered in an era of competition into the banking system.

Another major area of change is the system of credit delivery. In the pre-reform period the credit decisions of the banks were governed by the detailed regulations on the provision of cash credit for working capital, credit authorization, holdings of inventory and receivables of various industries, consortium arrangements etc. As a part of the reform process, most of the decision-making was left to the bank's discretion. Banks were given more freedom to set the credit requirements for their borrowers, conditions for consortium lending were also relaxed, the regulations on Maximum Permissible Bank Finance (MPBF) were withdrawn and banks were allowed to use their own methods in order to assess working capital requirements. In addition, banks were also allowed to use their discretion in levying commitment charges and deciding on the level of inventory and receivable holdings for different industries.

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The other important change in credit delivery was the expansion of the definition of priority sector lending. This substantially increased the maneuverability and also the individual accountability, responsibility and accountability of banks for their performance.

The other important changes have been in the prudential supervision norms. During the decade, these norms were gradually tightened. Specific changes included introduction of the capital adequacy norms and phased improvement in income recognition, asset classification and provisioning norms. One example for such tightening was the reduction in the time frame before an asset was categorized as an NPA from two quarters to a single quarter.

The trend

Generally it has been found that financial liberalization has a positive effect on bank performance. Evidence from various developing economies such as Columbia, Norway, Turkey etc., suggests that financial liberalization has had a beneficial effect on the banking industry and that foreign banks have higher profitability than domestic banks in developing countries. One of the interesting areas of study has been the impact of ownership on the banks' performance in developing countries. It is found to have a significant effect.

Empirical evidence in the Indian banking sector suggests that a larger share of state ownership is associated with higher intermediation costs. Another research concludes that "...even though foreign banks and private sector banks generally perform better than public sector banks in terms of profitability, earning efficiency and cost efficiency in the initial stage (of reforms), such differences have diminished as public sector banks have improved profitability and cost efficiency."

The sample for the present study includes all the commercial banks in India between 1991-92 and 2000-2001. By 2000-01, the state banks held 31% market share while nationalized banks had 48%, the old private sector banks had 7%, the new private sector banks had 6% and foreign banks commanded a share of 8%.

Findings

The research findings are focused on industry concentration, cost of financial intermediation and bank profitability, ownership etc.

In terms of the industry concentration, there has been a decline in the last decade. Due to the easing in the entry requirements, many new players have entered the market thus reducing the level of industry concentration. In particular, SBI's market share fell from 28% in the asset market to 24% between 1991-92 and 2001-02. In loans its market share has come down from 27 to 22% during the sample period. It is interesting to note that the combined assets of the three largest banks still comprise about one-third of the total assets of the banking system in 2001. In the case of the 10 largest banks, their share has consistently declined during the period of study and is just under 60% by 2000-01. All the banks, which form this chunk, are public sector banks. Many foreign and new private sector banks have snatched the market share from the public sector banks.

The impact of financial liberalization is also felt in the changes in the bank spreads and profitability. The study suggests that an increase in competition has lowered the spreads and profitability of Indian banks. The entry of new foreign and domestic banks and the concurrent decrease in industry concentration are associated with a significant decline in bank spreads and profitability. The determining factors of spreads and profitability include operating costs, priority sector lending, non-performing loans, investment in government securities and the composition of deposits. Cost ratio, the ratio of the operating costs to the total assets is the key explanatory variable of operational costs in India. It is also observed that (i) high level of priority sector lending is generally associated with significantly higher bank spreads, (ii) banks with higher NPAs have significantly lower profitability, (iii) large share investment in government securities is linked to higher spreads, (iv) banks with higher share of current deposits have significantly lower bank spreads and higher profitability. One of the surprising findings was that the number of branches does not have a significant effect on the profitability of Indian banks, but is positively and significantly related to the net interest margin.

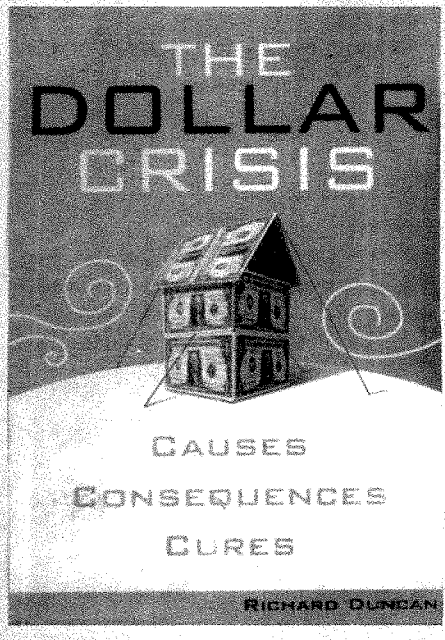
In terms of ownership, the study shows that new private sector banks have significantly lower bank spreads and higher profitability than old private sector banks. Foreign banks generally have higher bank spreads and higher profitability before provisioning than the old private sector banks. This higher profitability is in spite of the fact that foreign banks have high operating expenses. This can be explained by the fact that foreign banks maintain relatively higher spreads as well as their income from different type of services to customers as compared to the domestic banks. Nationalized banks have shown a lower profitability than private and foreign banks both before and after provisioning.

On the whole, the results of the study point out that successful performance of Indian commercial banks is dependant on their efficiency and their responsiveness to the changing markets. The author prescribes shifting ownership to private sector as a remedy to improve the lagging performance of nationalized banks.

D G Prasuna

BOOK SUMMARY

The Dollar Crisis
Causes, Consequences and Cures



Author: ***Richard Duncan***
Pages: *269*
Price: *Rs. 3150*
Publisher: *John Wiley & Sons.*

The world economy has been hit by a combination of corporate distress, accounting malpractices, and investment bank indecency. In the process, governments are begging for bailouts from IMF. The book explains the nature and origin of the imbalances that have destabilized the global economy. To get out of the crisis a joint effort is needed by all stakeholders.

The US dollar, which has been dominating the global financial environment for more than three decades, is now experiencing a slight depreciation. Though for any currency appreciation and depreciation are common, the depreciation of the dollar is a surprise to many. Since the 1980s, the dollar has been appreciating vis-à-vis other currencies backed by its ever growing exports and attractiveness of US as an investment avenue. In its heydays dollar was considered the world's core currency reserve in place of gold, which further helped the current international monetary system to evolve from the collapse of Bretton Woods. It allowed US to finance massive current account deficit by selling debt instruments to its trading partners instead of paying for its imports with gold as practiced under the Bretton Woods system or the gold standard. This standard practice guided the rest of the world and their products were sold to US on credit. This further helped in rapid economic growth to developing countries and led to a downward pressure on consumer prices.

However, after such Bull Run dollar standard also resulted in a number of undesirable and potentially disastrous consequences. While there are many reasons that can be attributed to the depreciation of the dollar, prominent among them are swelling US trade gap, gloomy economic environment, war with Iraq and falling investor confidence in the US markets which was triggered by a combination of corporate distress, accounting malpractices, investment bank indecency, corporate governance and other geopolitical considerations. However, economists feel that the US trade gap may not be the major catalyst as from 1998 to 2001, the US trade deficit worsened from –2.5 to –4.5%.

The book demonstrates the flaws in the international monetary system responsible for that disequilibrium which would soon finish the value of US dollar and a worldwide economic slump. This crisis would be

referred as dollar crisis as it originated from the excessive creation of dollar reserve assets and must culminate from the collapse of the value of dollar. The theme is that the global economy has been destabilized by the US enormous trade deficit, which now exceeds $50 mn—1.5% of Global GDP per annum. That trade imbalances, financed through debt, has created tremendous disequilibrium in the global economy and an economic bubble in the US. When that bubble pops and the global economic disequilibrium unwinds, the world will not be able to avoid a very serious economic crash. Therefore, it needs joint efforts by different stakeholders to overcome an upcoming monetary crisis. The world cannot afford to ignore the lessons of the Asian and Latin American financial crises—and Japan's depression—as an even greater economic threat appears.

Origin of economic bubbles and flaws in dollar standard

With the breakdown of the Bretton Woods international monetary system, trade imbalances have flooded the world with liquidity, causing economic overheating and hyperinflation in asset prices, initially within individual countries and now at global scale. In earlier days, gold and silver were used as international reserve assets, which countries used to imbalance their international trade and capital flows but now it comprises of foreign exchange, primarily US dollars. The factors that led to the use of dollar as the standard currency are due to heavy investments by US corporations overseas and at the same time, many countries started to hold increasing amount of dollars reserve in exchange for gold at US Federal Reserve. The US was unique in other ways as absolute size of its trade was extraordinarily large and also it was the only country that was able to finance its growing level of indebtedness to the rest of the world by issuing debt instruments denominated in its own currency. It further resulted in widening the trade imbalances between the US and the rest of the world for over the last three decades. It is indicative of extraordinary expansion of credit that those trade imbalances facilitated. In addition, this credit expansion caused investment boom and asset price inflation in equity and property prices. However, the excess of credit ultimately ended up in deflation as purchasing power of people did not increase in line with the capacity to produce. Thus trade imbalances and trans-border capital flows are responsible for the current extraordinary disequilibrium in the global economy. The countries that build up large stockpiles of international reserves due to large current account or financial account surpluses—such as Japan in the 1980s, the Asian countries in the 1990s and China today—develop bubble economies. When those bubbles pop, as they inevitably do, they leave behind banking crises and excess capacity. The governments of those countries must then go deeply into debt to bailout the depositors of the failed banks. At the same time, the excess capacity in the economy results in deflation. Economic bubbles and systemic banking crises can be expected to reoccur and deflationary pressure can be expected to persist so long as the US Current Account deficits continue to flood the world with dollar liquidity.

One can understand these imbalances of trade through balance of payment frameworks which comprises of two main groups of accounts, the current account which pertains to transactions in goods and services between countries and the other is capital and financial account that pertains to capital transfers and financial assets and liabilities. In short, a country with a current account surplus sells more in goods and services to other countries than it buys from other countries. A country with a surplus on its capital and financial account has experienced more capital inflows than capital outflows. These surpluses lead to accumulation of reserve assets excess of which does pose a severe problem for economic policy. As a consequence, bubble economies, characterized by extreme economic overheating and hyperinflation in asset prices, develop in their countries and then burst, leaving their financial sectors in tatters and their governments deeply in debt. Thus, countries that have successful strategy of export-led growth have built up enormous foreign exchange reserves comprising of US dollar-denominated debt instruments have suffered tremendously from the economic overheating and hyperinflation in asset prices which were by-products of their surpluses.

Global recession and the death of monetarism

With the collapse of Bretton Woods international monetary system after its last meaningful ties between paper money and gold, US dollar replaced gold as the world's reserve currency in which most international trade transactions were conducted. The international monetary system that evolved out of the collapse of the Bretton Woods system brought about extraordinary disequilibrium in the global economy. One of the flaws is that it caused unsustainable asset price bubbles, both in the countries with large balance of payments surpluses and in the US, the principal deficit country. Asset price

About the Author

Richard Duncan has worked as a financial analyst in Asia for more than 16 years, conducting research and publishing investment reports on companies, industries, and economies from India to Korea. He studied economics and literature at Vanderbilt University and business and finance at Babson College.

bubbles are ephemeral by nature. When they pop, they tend to cause systemic-banking crisis that require costly financial sector. Though the debt is equivalent to 60% of GDP and huge unfunded contingent liabilities for the social security system, the US Government's financial position is not good. However, the ability of the US to fund large-scale Keynesian stimulus is the greatest hope that this recession will not spiral into crisis.

The current global economic crisis is one of excess capacity that has resulted from excessive credit expansion. Initially, as the global money supply expanded on the back of surging dollar liquidity, great profits were generated which were deposited into the banks around the world. Those deposits enabled banks to provide new loans that further stimulated the economic expansion. This expansionary cycle continued until asset price bubbles formed and excessive industry capacity came into existence. At that point, large portion of the loans that had fueled the boom could not be repaid, and large portions of the deposits were lost. The cause and effect relationship between surging international assets and systemic bank failures is very direct.

The countries having large and growing current account surpluses with US have bought its equities, which further helped them along in the growth of their economy. But with the economic disaster their exports to the US declined. Consequently, the possibility of an appreciation in their currencies against the dollar represents a grave threat to their prosperity. To avoid that scenario, the surplus nations have to buy either existing US dollar-denominated assets or new dollar-denominated assets as they are issued. The fate of the dollar in the near term may hinge on how quickly and how much the US budget deficit widens. Therefore, as long as dollar remains at or near its current levels, the US current account deficit will continue to generate unsustainable asset price bubbles and deflation around the world. There are two reasons why the current trade arrangements are deflationary. The first is an increasing proportion of the manufactured goods in the world are made with very low-cost labor; consequently, the price of those goods is falling because they cost less to make. Secondly, the trade imbalances generate reserve assets that fuel credit creation and over-investment. Over-investment causes excess capacity and excess capacity causes deflation.

Thus, the consequences were severe in the form of recession in United States. In the first phase of new paradigm recession, economic growth rates decelerated abruptly, stock markets spiraled downward, commodity prices fell, and government finances came under strain all around the world. And in the second phase of recession, which is about to begin, would result in sharp decline in personal consumption expenditure and drop in investment. Both the fall in consumption and investment will result in sharp reduction in imports, which throws the world into recession. But then with the lowering of interest rates, American consumers continue to increase their indebtedness and their consumption. Future development will show that this aggressive monetary easing was nothing more than a palliative that merely prolonged and exacerbated the disequilibrium in the economy. The longer the disequilibrium, the more painful will be the inevitable adjustment process when it corrects. Having said all this, falling interest rates and the rapid increase in home prices have sparked off a refinancing extravaganza that is putting more money in the hands of consumers even as every aspect of the economy worsens. But the inevitable correction of the US current account deficit will bring the era of export-led growth to an end and mark the dawn of difficult new age for the global economy.

At one time interest rate reduction, combined with a well-timed tax cut, did help bring about a little dead cat bounce in the economy. But in the second quarter, however, US GDP figures were heading quickly back to earth. Monetarist approach of increasing money supply is no cure for deflation that results when a credit bubble pops. Central banks cannot overcome deflation in this post-bubble environment by lowering interest rates and bumping up the money supply. You cannot fight liquidity with liquidity.

Policy tools for the 21st century

In economics, the core problem with the global economy can be explained in terms of imbalance of supply and demand. And in the expansion phase of the cycle, an enormous credit was created around the world. This gap

Snapshot

- The US economy rightly described as the world's engine of economic growth, is now beginning to falter under the immense debt burden of its corporate and consumer sectors.
- Today, gold only makes up a small percentage of the world's reserve assets. The bulk of reserves now comprise of foreign exchange.
- Trade imbalances and trans-border capital flows are responsible for the current extraordinary disequilibrium in the global economy.
- All credit bubbles ultimately end in deflation because the purchasing power of the public doesn't increase in line with the capacity of the industry to produce.
- With their dollar surpluses nations must buy US dollar-denominated assets if they are to avoid converting those dollars into their own currencies and killing the goose that laid the golden eggs.

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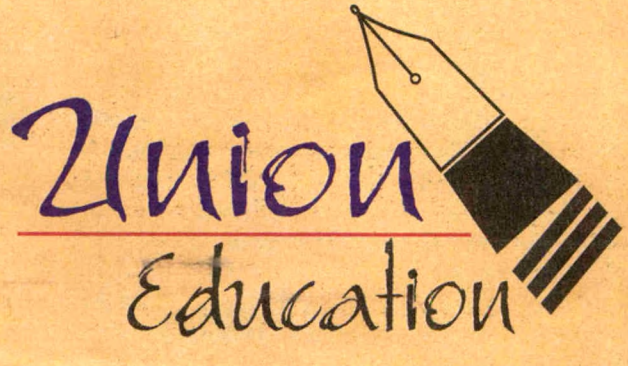

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between aggregate supply and sustainable demand supported by purchasing power is so great that without government intervention, supply would collapse with an extended deflationary process. Unfortunately, huge differences in wage rates between the newly industrializing countries and the developed world resulted in trade imbalances of an unprecedented magnitude and those imbalances created tremendous disequilibrium in the global economy.

On the other side, well-paid workforces is a prerequisite for the development of a fully industrialized economy and apply this lesson to newly formed global economy. Therefore raise the wage rates of industrial workers employed in export industries in developing countries through coordinated government intervention. Increasing wages in the developing world would augment global aggregate demand. It would succeed in putting more money in people's pockets, something that traditional monetary policy is incapable of doing in a post-bubble environment. And it is only possible if the purchasing power would increase in line with wage growth. Therefore, this challenge would be taken by interventionist solutions that are formulated to resolve such economic crisis.

In its first place, stimulate global economy through raising wage rates in developing world and then convince a few people in positions of the highest authority that such a plan was both necessary and efficacious though it is very difficult to come to a consensus on such things, are only theoretically possible. In the second step, negotiations are necessary to reach an agreement such as conducting a special session of World Trade Organization. The World Bank could be helpful in disseminating the ideas and in collecting feedback through its ongoing dialog with all the governments of the world. Step three would involve reaching an agreement on two things: The initial minimum wage rate and how quickly that rate should be increased in the subsequent years. It would be important to harmonize those rates as quickly as possible, so that no one country would have competitive advantage over the others. And at the end, the success of this scheme would very much depend on verifying that the industrial workers were in fact being paid minimum wage.

A new international monetary accord is in need. The new system must prevent persistent trade imbalances, and it must put in place a mechanism that would allow the growth of the global money supply to be controlled and allocated in an orderly and rational manner. Otherwise, the existing flaws in the international monetary system are going to continue destabilizing the global economy as they have been over the last two decades. It may be hard to adjust to this fact, but a global Central Bank is needed to control the global money supply. The IMF has the organizational structure and many of the policy tools [including to authority to create Special Drawing Rights (SDRs)] needed to carry out the role of a quasi-Global Central Bank. However, the Fund must now master three important tasks if it is going to succeed in that role. First, the IMF must gain control over the global money supply—that is over the creation of international reserve assets. Second, it must learn how to allocate the future supply of global liquidity (SDRs) in quantities that are neither excessive nor too sparse. Finally, it must learn how to allocate the global money supply in a way to ensure global economic stability and, simultaneously, support the global development agenda.

Gaining control over the global money supply is the first step. That would stop the excessive credit creation responsible for the bubble economies and systemic banking crises that have occurred around the world in recent decades. However, gaining control over the global money supply would not be sufficient to prevent the inevitable correction of the US current account deficit from ending in a severe and protracted global recession. The countries that are now dependent on export led growth must develop new sources of domestic demand and this could be achieved by an international initiative to put in place a global minimum wage.

According to some experts, the depreciation of the dollar can be a temporary phenomena if the confidence in the US markets regains. Along with that, the slight signals of US economy recovering ahead of Europe will enable the resurgence of the dollar. As feared by economists, a prolonged decline in dollar can happen only if the US stocks continue their downward slide. In addition, there is a strong argument that the dollar will not depreciate further. Since there are only four major currencies around the world (dollar, euro, yen and sterling), the players will not allow large relative movements of any of these currencies. For example, if the dollar depreciates relative to other major currencies, then the other currencies will appreciate. This would place exporters with costs in these currencies at a competitive disadvantage. Hence, the exporters will force their governments to maintain valuation levels. Additionally as long as dollar-denominated assets remain in demand, further depreciation of the dollar may not be possible. As the feared synchronized worldwide recession gains momentum, wealth holders will seek a safer haven. The US trade deficit provides dollar income and dollar assets that will be increasingly in demand as domestic markets in euro and other major nations worsen. These factors will propel the dollar to regain its lost ground in the coming future and ascertain its dominance over the global economy once again.

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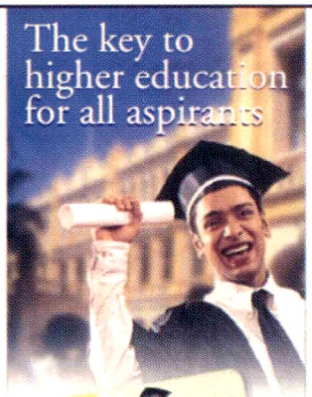

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